Chapter 19 Transfers Of Property Between Foreign Corporations And U.S. Persons: IRC §367

Contents:

References:

Revenue and Taxation Code Section 24451(formerly Sections 24502, 24521, 24531, 24532, 24533,24535, 24536, 24537, 24538, 24539, 24551, 24561, and 24562)
Internal Revenue Code Section 367
Internal Revenue Code Section 332
Internal Revenue Code Section 351
Internal Revenue Code Section 354

Internal Revenue Code Section 355
Internal Revenue Code Section 356
Internal Revenue Code Section 361
Internal Revenue Code Section 368
Temporary Treasury Reg. 1.367(a)-1T through 1.367(e)-2T including the Temporary Regulations under 7.367(b)

Training Objectives:

By the end of this chapter you will be able to do the following:

1. Understand the purpose of Internal Revenue Code (IRC) §367.
2. Determine which transfers of property under the nonrecognition provisions of the IRC are subject to gain recognition as a result of the application of §367.
3. Determine which code sections are controlling when a transaction falls within the provisions of several code sections.
4. Identify the differences between California and federal law with respect to transactions subject to IRC §367.
5. Determine the gain recognizable for California purposes when a transfer of property is subject to the provisions of IRC §367.

Section 19.1 Introduction

Contents:

a. Background Information

Virtually the entire system of U.S. taxation of overseas operations can be understood as an elaborate corollary of (and reaction to) the basic premise that foreign corporations are separate taxpayers not generally subject to U.S. taxation. At the heart of the U.S. governments efforts to currently tax foreign earnings is the risk that a domestic corporation, through the use of a foreign affiliate(s), may defer U.S. taxation of foreign-source income indefinitely. The rewards for deferring U.S. taxation are obvious where the foreign tax rates imposed on a corporation are lower than the U.S. rate that would have been imposed absent deferral.

The decrease in the U.S. marginal tax rates, combined with the elimination of preferred treatment of capital gains income and the elimination of deferral of U.S. taxation for "tax haven" and passive income activities, has eliminated many of the opportunities and advantages for deferring foreign-source income that were previously available through the use of controlled foreign corporations (CFC's). However, deferral of U.S. taxation is still possible and advantageous for some foreign business activities. Internal Revenue Code (IRC) §367 further erodes the benefits of deferral available where property is transferred, or deemed to have been transferred, outside the U.S. taxing jurisdiction. When this code section is combined with other anti-abuse provisions of the Code, including IRC Sections 482 and 1502, deferring U.S. taxation on foreign-source income becomes more difficult to realize.

IRC §367 generally requires gain recognition when property is transferred to foreign corporations even though other code sections (IRC §351, 361, etc,) permit nonrecognition of gain.

Prior to the enactment of water's-edge legislation[1], deferral of foreign income was generally not an issue for California purposes. All income of a unitary business group, including the income of unitary foreign affiliates, was includible in the combined report for purposes of calculating income attributable to California. Foreign entities that were not unitary and that were not taxpayers, were permitted to permanently defer taxation on foreign-source income for California purposes, or to defer taxation until such income was repatriated to the U.S. in a taxable transaction.

Gains realized from certain tax-free transfers between unitary U.S. affiliates and nonunitary foreign affiliates could be recognized in certain instances, as a result of R&TC §24561 (IRC §367) but intercompany gains between unitary affiliates triggered as a result of R&TC §24561 (IRC §367) would be deferred or eliminated until the property was transferred to an unaffiliated third-party or converted to nonbusiness use. With the enactment of the water's-edge statutes, the ramifications of R&TC §24561 on certain tax-free transactions have extended to transfers between U.S. affiliates and unitary foreign affiliates excluded from the water's-edge combined report. This manual section is intended to discuss the transactions affected by IRC §367, and the effect of §367 on both water's-edge and worldwide combined reports.

b. Overview Of The Internal Revenue Code Nonrecognition Provisions

Subchapter C of the Internal Revenue Code (specifically, Sections 332, 351, 354, 355, 356, and 361) provides for the nonrecognition of gain by a transferor of assets or stock in connection with certain exchanges involving corporate formations, reorganizations, or liquidations. As a general rule, the Subchapter C nonrecognition provisions require corporate status of the parties to the exchange to allow nonrecognition treatment of the gain. Absent IRC §367 and other anti-tax avoidance provisions of the Code, such as IRC §482, appreciated property of U.S. persons could easily be transferred offshore to foreign corporations beyond the reach of the U.S. taxing jurisdiction by utilizing one of these nonrecognition provisions in the Code.

c. Interaction Of IRC §367 And The Nonrecognition Provisions Of Subchapter C Of The Code

Internal Revenue Code §367 was enacted to substantially limit the availability of nonrecognition treatment for gains resulting from transfers of appreciated property between U.S. persons and foreign corporations. The scope of IRC §367 is intended to be extremely broad. It applies to virtually any direct, indirect, or constructive transfer between a U.S. person and a foreign corporation. In some instances, even transfers that appear not to involve such transfers or exchanges may fall within the scope of Internal Revenue Code §367. Internal Revenue Code §367 generally either requires current gain recognition, or requires the parties to the transaction to enter into a gain recognition agreement to avoid current recognition of the gain in question.

d. Summary

This section provided a basic overview of the interaction of IRC §367 with the U.S. system for taxing overseas operations and the nonrecognition provisions of Subchapter C of the IRC. In addition, interaction of IRC §367 with the California reporting methods is also briefly discussed. The next section discusses the interaction of IRC §367 with the California combined report. A discussion of the federal rules commences with Section 19.3, Water's-Edge Manual.

- At one time substantial economic benefits could be obtained by deferring U.S. taxation of foreign-source income.
- The benefits of deferring U.S. taxation of foreign-source income have been substantially reduced by recent tax reform changes, but they have not been eliminated.
- Internal Revenue Code §367 is an anti-tax avoidance provision that further reduces the ability to defer income when property is transferred, or deemed to have been transferred, outside the U.S. taxing jurisdiction in an otherwise non-taxable exchange.
- Under worldwide combined reporting, transfers subject to IRC §367 do not generally represent an issue for California purposes when the parties and the property involved in the transfer remain within the worldwide unitary group. However, under water's-edge combined reporting transfers subject to the provisions of IRC §367 could represent significant audit issues.
- Internal Revenue Code §367 applies only to gains that otherwise would not be recognized as a result of the nonrecognition provisions of subchapter C of the Internal Revenue Code.

Footnotes

1. Senate Bill 85 (Stats. 1986, Ch. 660) originally enacted the water's-edge statutes in 1986, effective for income years beginning on or after 1/1/88.

Section 19.2 IRC §367 And The California Combined Report

Contents:

a. Background Information
b. In General
c. IRC §367 and its Interaction with the Intercompany Transaction Rules
d. IRC §367 and the California Examination
e. Summary

Training Objectives:

The subsequent sections of this chapter explain how IRC §367 affects gains realized in transactions subject to the nonrecognition provisions of the Internal Revenue Code. This section discusses the similarities and differences in California and federal law when IRC §367 applies to a transaction. In addition, this section discusses issues that are unique to the California examination.

At the end of this section, you will be able to do the following:

1) Determine the differences between California and federal law with respect to transactions that fall within the provisions of IRC §367.
2) Determine the effect of the intercompany transaction rules on transactions that fall within the scope of IRC §367.
3) Identify whether an IRC §367 transaction occurred during any income year under examination.
4) Identify whether a transaction subject to IRC §367 generated unrecognized gain during an income year prior to the income year(s) under examination, and as a result of the occurrence of a triggering event during the income year(s) under examination, gain may be required to be recognized.
5) Determine the gain recognizable for California purposes resulting from a transaction subject to the IRC §367 provisions.

a. Background Information

For income years beginning in 1983 and thereafter, California Revenue and Taxation Code (R&TC) §24561 conformed to IRC §367 with respect to the treatment of property transferred to controlled corporations by incorporating stand-alone language mirroring the IRC's language into the R&TC. There were minor exceptions to this conformity. For income years beginning on or after January 1, 1987, R&TC §24561 was reworded to incorporate the provisions of IRC §367 by direct reference, and the R&TC's previous stand-alone language mirroring the IRC's language was eliminated. However, minor differences between state and federal law remained. Finally, effective for income years beginning on or after January 1, 1991, the R&TC was conformed to Subchapter C of the Internal Revenue Code in its entirety by direct reference, and Revenue and Taxation Code §24561 was renumbered as R&TC §24451.

b. In General

As a general rule, California law is the same as federal law with respect to the taxation of inbound and outbound transfers of property between foreign and domestic affiliates under IRC §367. Specifically, a transfer between a foreign corporation and a U.S. person that falls within certain nonrecognition provisions of Subchapter C of the Internal Revenue Code will result in gain recognition unless the transfer meets one of the exceptions to gain recognition listed in IRC §367.

Although California has substantially conformed to the treatment of gains under IRC §367, there are a few important differences between California and federal law worth noting. These differences are as follows:

1. For California purposes, a transferor can receive both stock and securities in the transferee corporation and the transfer will qualify for nonrecognition treatment under IRC §351. For federal purposes, only stock can be received by the transferor from the transferee in order for the transfer to qualify for nonrecognition treatment under IRC §351. Any gain realized as a result of transferring other securities in a §351 transaction will be recognized for federal purposes but not for California purposes. This difference is effective for transfers between October 3, 1989, and July 30, 1990.[1]
2. Under IRC §351(e)(1), a transfer of property to an investment company does not qualify for nonrecognition treatment for federal income tax purposes. The California Revenue and Taxation Code does not follow provisions applicable to foreign investment companies.[2] Accordingly, property transferred to an investment company would qualify for nonrecognition treatment for California purposes.[3] A state adjustment would be required to remove any reported gain from federal taxable income. This difference applies to any open income year.
3. California did not conform to IRC §354 with respect to exchanges under the final system plan for Conrail for income years beginning prior to January 1, 1991.[4]
4. For income years beginning on or after January 1, 1987, and before January 1, 1990, California did not conform to IRC §355(c).[5] The effect of California's failure to conform to this IRC provision is as follows:IRC §311 provides that no gain or loss will be recognized by a distributing corporation

upon distribution of its own stock or unappreciated property, while distributions of appreciated property (including stock) will result in gain recognition to the distributing corporation. IRC §355(c)(3) provides that IRC §311 will not apply, and gain will not be recognized by a distributing corporation where appreciated stock of a corporation controlled by the distributing corporation is distributed or where IRC §356 applies as it relates to IRC §355, and the distribution is not pursuant to a plan of reorganization. Distributions of appreciated property, other than stock described in IRC §355(c)(1), remain subject to gain recognition under IRC §311.Since IRC §311 does not apply to a transaction described in IRC §355(c)(1), gain is not recognized on distributions of appreciated stock in a controlled corporation for federal purposes. Since California did not conform to IRC §355(c) for income years beginning on or after January 1, 1987, and before January 1, 1990,[6] gain would be recognized on a distribution of appreciated stock in a controlled corporation by the distributor for California purposes because IRC §311(b) applies to the transaction during the time period California was not in conformity with IRC §355(c). An adjustment would be required to include the gain excluded from federal net income as a result of the application of IRC §355(c).

5. IRC §355(d) is effective for disqualified distributions occurring after October 9, 1990, unless the distribution is made pursuant to a binding written contract in effect on October 9, 1990. California conformed to IRC §355(d) effective for income years beginning on or after January 1, 1991. Accordingly, California does not conform to IRC §355(d) effective for distributions after October 9, 1990, and before the first day of the income year beginning on or after January 1, 1991, for which there is not a binding written contract in effect on October 9, 1990. Refer to IRC §355(d) for more information.
6. For income years beginning on or after January 1, 1987, California conformed to the treatment of gain or loss under §1248. R&TC §24990.7 terminated California's conformity to IRC §1248 effective for transactions occurring after August 20, 1990, in income years beginning on or after January 1, 1990.For federal purposes, gains from inbound transfers described by IRC §367(b) may be treated as either dividend income under IRC §1248, or as ordinary income under IRC §1246, depending upon the transfer involved. California conformed to dividend treatment under IRC §1248 for gains realized from inbound transactions described by IRC §367(b) during the time period California conformed to IRC §1248. Dividend relief may potentially be allowed (under R&TC §24402, 25106,

24411, or 24410, as appropriate) for California purposes for any amount treated as a dividend because of this temporary conformity to IRC §1248.[7] For gains recognized from inbound transfers occurring after August 20, 1990, in income years beginning on or after January 1, 1990, California no longer conforms to the provisions of IRC §1248.[8] Accordingly, any "Section 1248 amount" included in the computation of federal taxable income as a result of IRC §367(b) would not be includible in the computation of California taxable income because the provisions of IRC §1248 no longer apply for California purposes. Since California specifically did not conform to IRC §1248, a state adjustment would be required to reduce California taxable income by the amount of any §1248 deemed distribution included in the computation of taxable income as a result of the application of IRC §367(b).

Example:

A taxpayer files a worldwide combined report including its unitary foreign affiliates. Stock in a unitary foreign subsidiary, which was a CFC, was transferred in a IRC §368(a)(1)(C) reorganization to a foreign corporation unrelated to the domestic transferee corporation. In the exchange, the domestic corporation received stock in the unrelated foreign corporation. Because of the loss of the transferred foreign corporation's status as a CFC, the transferring domestic corporation is required to include in income the "Section 1248 amount" as a deemed distribution for federal purposes. If the transaction occurred outside of the window period of California's conformity to §1248, "the Section 1248 amount", would not apply for California purposes.

On the other hand, if the "all earnings and profits amount" and "the additional earnings and profits amount" computed under the principles of IRC §1248 are included in the computation of federal taxable income, then it will also be included in California taxable income for all open years. Amounts computed under the principles of IRC §1248 are included in California taxable income because although the principles of IRC §1248 are used to compute "the additional earnings and profits amount", the amount so calculated is not treated as a distribution under IRC §1248 for federal purposes. Accordingly, no adjustment would be required to remove either the "all earnings and profits amount" or "the additional earnings and profits amount" from the computation of California taxable income. Any amount included in the computation of California taxable income as either the "all earnings and profits amount" or the "additional earnings and profits amount" is treated as an actual distribution taxable under IRC §301,[9] and is potentially subject to one of California's dividend deductions.

Most of these differences are the result of California's failure to timely conform to the relevant federal statute.

c. IRC §367 And Its Interaction With The Intercompany Transaction Rules

1. In General

California conforms to IRC §367 with minor differences. These differences are generally the result of either California's failure to conform to the Internal Revenue Code in its entirety, or due to timing differences in California's conformity to federal legislation. However, intercompany transactions between foreign and domestic corporations included in a combined report may also modify the tax implications of an IRC §367 transaction for California purposes. The following discussion explains the differences between federal and state taxing jurisdictions, and the resulting effect of the differences in taxing jurisdictions and California's intercompany transactions rules on property transfers within the scope of IRC §367.

2. Different Taxing Jurisdictions

California and federal methods of taxing persons within their jurisdiction differ. For federal purposes, U.S. incorporated entities are taxed on all their income regardless of whether its source is within or without the U.S., and foreign corporations are generally subject to tax only on their U.S.-source income. For California purposes, only income from sources within California can be taxed. In addition, California taxpayers can choose whether to file on a worldwide or water's-edge basis. This substantial difference in taxing jurisdictions, coupled with substantial differences between federal and state sourcing rules, can significantly alter the tax implications of an IRC §367 transaction for California purposes.

3. Factors Affecting Tax Treatment Of §367 - Transactions For California Purposes

For California purposes, the tax implications of an intercompany transfer subject to the provisions of IRC §367 will depend upon the following:

A. The taxpayer's method of filing for California purposes (worldwide, separate entity, or water's-edge);
B. The relationship between the corporations transferring property subject to gain recognition under IRC §367 (unitary or nonunitary);
C. The taxpayer's previous methods of filing (worldwide, separate, or water's-edge); and
D. The transfer involved.

These factors, combined with the differences in the state and federal taxing jurisdictions and the intercompany transaction rules, can result in significantly different tax consequences for California and federal purposes.

4. The Pending Draft Intercompany Transaction -Regulations Under R&TC §25106.5

The FTB has prepared draft regs, that once adopted, will provide guidance on how to treat gains and losses resulting from transactions between members of a unitary group filing a combined report. These regs will apply to both TPs filing a worldwide combined report and TPs filing on a water's-edge basis. The draft regs have not been finalized as of the writing of this text. Until these regs are adopted, the department's current position on the treatment of intercompany transactions is covered in Chapter 17, Water's-Edge Manual

5. Intercompany Transactions Defined

Intercompany transactions are transactions that occur between corporations which are members of the same combined reporting group at the time the transaction occurred. The term "group" means the affiliated corporations (or portions thereof) properly included in a combined report. To the extent that a corporation is excluded from the water's-edge combined report as a result of a water's-edge election, that corporation is not considered to be a member of the combined reporting group. A group member will be deemed to have left the group in any year in which it is not properly included in a combined report which includes at least itself and the corporations (or successor thereto) which were directly a party to the intercompany transaction.

6. California Treatment Of Intercompany <u>TRANSACTIONS</u>

As a general rule, the elimination/basis transfer method is used to report gains and losses from intercompany transactions. California does not conform to the federal intercompany transaction rules. However, California FTB Publication 1061 provides that California will follow the TreasRegs. §1.1502-13 deferred intercompany transaction rules only with respect to the following listed intercompany transactions:

- the sale or exchange of business fixed assets;[10]
- the performance of services where the amount of the expenditure for such services is capitalized; or
- any other expenditure where the amount of the expenditure is capitalized.

Any deferred gain or loss must be included in the computation of combined report income upon the occurrence of one of the following:

- disposition of the property outside the group, including abandonment; or
- cessation of the transferor or transferee of the property as a member of the combined reporting group (whether or not such member remains an affiliated corporation).

When the elimination/basis transfer method is used, any gain or loss that would otherwise be recognized from an intercompany sale or exchange is eliminated, and the seller's basis carries over to the buyer. This is intended to be a broad overview of the department's current position on intercompany transactions. The department's position may change or be modified once the regulation's are adopted. Refer to Chapter 17, Water's-Edge Manual for a discussion of the current California tax treatment of intercompany transactions.

7. Treatment Of Transfers When IRC §367 And The Intercompany Transactions Rules Apply To The Same Transfer

Federal/state differences may occur when a transfer of property falls within the provisions of IRC §367, and is also an intercompany transaction for California purposes. For federal purposes, §367 will require gain to be recognized in the year of the transaction. If the transaction is an intercompany transfer (because the corporations are included within a combined report), of intangible assets or inventory for California purposes however, then the §367 gain would be eliminated and the transferor's basis would carry over to the transferee. In most cases, this is essentially the same result as if the non-recognition provisions continued to apply to the transaction.

If the transaction is an intercompany transfer of business fixed assets, then without §367 there would be no gain to defer. If §367 applies to the transaction however, then the gain is deferred in the year of the transaction but will be recognized in a subsequent year when a triggering event occurs.

Losses deferred under the intercompany transaction rules do not fall within the provisions of IRC §367 (i.e, §367 only applies to gains). Further, any losses would not be currently recognized because of the application of IRC §267, which generally prohibits the recognition of losses between related parties. Such losses would only be recognized when the property in question was abandoned, or transferred to an unrelated third-party. The amount of reportable loss would be determined under the applicable R&TC Section. (See Chapter 15A, Water's-Edge Manual for a discussion of IRC §267).

d. IRC §367 And The California Examination

1. In General

IRC §367 can be a significant issue in the California examination. The taxpayer(s) may have deferred intercompany gains from §367 transactions in prior income years which are triggered as a result of a water's-edge election[11] (or some other triggering event), or the taxpayer(s) may have transfers or exchanges during the income years under examination to which IRC §367 applies. IRC §367 transactions occurring during any income year under examination can be identified on worldwide and water's-edge returns (a statement describing the §367 transaction should be attached to the return). The tax effect of any transaction will depend on the interaction of many factors.

The remainder of this section will address transfers under IRC §367 for which realized gain must be recognized, and gains under IRC §367 which were previously deferred and which must now be recognized as a result of the occurrence of a triggering event.

2. Scoping The Return

In most instances, California's treatment of a transaction subject to IRC §367 will be the same as for federal purposes, absent the application of the intercompany transaction rules and differences in federal and state law. An auditor may discover during the initial scope of the tax returns under examination, or during the course of the audit, that the taxpayer has entered into an exchange subject to gain recognition under IRC §367, or that the taxpayer has met the reporting requirements for disclosing a transaction subject to the provisions of IRC §367 but has not reported gain as required by statute.

There are many ways to identify whether the taxpayer entered into an exchange(s) subject to the provisions of IRC §367, including the following methods:

A. Review the Schedule M-1 detail attached to the U.S. 1120;

B. Review supporting statements attached to the U.S. 1120 or California return for a written statement that an exchange subject to the provisions of IRC §367 occurred during the taxable year;
C. Review Page 1 of the California Form 100 for reported state adjustments recognizing the difference in gain reportable for California purposes;
D. Review other income schedules for ordinary income reported as a result of the application of IRC §367;
E. Review Schedule C attached to the U.S. 1120 for dividend income reported as the result of the application of IRC §1248;
F. Review Schedule D and Form 4797 attached to the U.S. 1120 and/or California Form 100 to identify gains reported as a result of the application of IRC §367;
G. Review any Federal Audit Reports available for adjustments relating to IRC §367 exchanges;
H. Review the list of foreign affiliates included in the California combined report to identify dispositions during the income year;
I. If there are any changes in the balance sheet which are not explained in the tax return, ask the taxpayer whether any exchanges of stock or property occurred during the income year;
J. Review other deduction and other expense schedules attached to the tax return for research and development expenditures (this information may help you determine whether the taxpayer has any intangible assets that may not be recorded on the books or that may have been transferred to a foreign affiliate);
K. Review the Form 5471's and 5472's for intercompany transaction information or IRC §367 disclosure statements;
L. Review any explanatory statements attached to the return;
M. Review the financial statements or annual reports for information on corporate restructuring; and
N. Review the prior audit report if it is available.

This list is not meant to be all-inclusive. Any one of these steps could identify the existence of an exchange subject to IRC §367.

3. The California Examination

A. In General

Since California law generally conforms to federal law with respect to transfers subject to IRC §367, most large case examinations should verify that any transfer was correctly reported for California purposes, and wait for the result of the federal examination to determine whether the reported federal gain (before state adjustments), if any, was correctly determined. The primary audit issues in this area will involve situations where there are differences between California and federal law, situations where the IRS is not auditing the taxpayer, or situations where intercompany transactions that fall within the provisions of IRC §367 are involved, including previously deferred intercompany gains that fell within the provisions of IRC §367 which must be recognized during an income year under examination as a result of the occurrence of a triggering event.

B. Steps In The Audit Process

During the initial scope of the tax returns or during the course of the audit, the auditor may discover either that the taxpayer entered into a transaction during the income year to which IRC §367 applies, or a triggering event occurred during the income year which would require previously deferred gains to be reported. The taxpayer may or may not have actually included the §367 gains in California net income.

The auditor will need to identify the transfer involved, the applicable nonrecognition provision(s), the IRC §367 provision(s) requiring gain recognition, and the gain recognizable as a result of IRC §367 for federal purposes.

Once the federal recognizable gain has been determined, the auditor will then need to ascertain the following:

- Whether California law conforms to federal law with respect to the transfer;
- Whether the gain is subject to elimination or deferral under the intercompany transaction rules;

- Whether a triggering event occurred during the income year which would require previous deferred IRC §367 gains to be recognized; and
- If a triggering event did occur, are there any deferred IRC §367 gains from prior income years which must be recognized during the income year(s) under examination. Events that would potentially trigger deferred-gain recognition would include entering into a water's-edge election, sale of unitary affiliate, depreciating or amortizing the transferred property, and disposition of the transferred property outside the group.

Identifying previously deferred intercompany gains can be one of the more difficult aspects of examining the IRC §367 issue, especially where foreign-to-foreign transfers are involved. Potential sources for identifying previously deferred gains would include, but are not limited to, prior year(s) Forms 5472, prior year(s) annual reports, prior year(s) audit reports, prior year(s) returns, and prior year(s) financial statement elimination workpapers. In some situations, however, the information necessary to fully examine the transaction may not be available (in the case of foreign-to-foreign transactions), or may have been destroyed as part of the taxpayer's normal business records destruction policy (in the case of business transactions that occurred many years prior to the years under examination).

C. Other Issues

Additional issues that will be present for California purposes will include:

A. the interaction of the intercompany transaction rules with respect to gains recognizable on transfers involving tainted assets under IRC §367(a); and
B. the recognition of any previously deferred intercompany gains as a result of no longer being able to include the foreign corporation organized in the contiguous foreign country in the water's-edge combined report once less than 100% of the capital stock is owned by a domestic corporation.

e. Summary

A wide variety of issues can exist in the examination of any California return. The issue of gains reportable under IRC §367 is not a new issue for California purposes. However, this issue will be more common now that taxpayers can elect to file on a water's-edge basis and exclude those entities with which they are entering into transactions subject to the provisions of IRC §367. The transactions subject to IRC §367 can be simple, or they can be extremely complex. Accordingly, the auditor should carefully analyze the transaction(s) involved to determine the applicable code sections, the effect of the transaction for federal purposes, and the effect of the transaction on net income for California purpose after considering federal/state differences in the applicable statutes, and the intercompany transaction rules. Care should also be exercised to identify previously deferred intercompany gains when a triggering event occurs during an income year under examination. A water's-edge election is a common triggering event which will cause any previously deferred gains to be recognized. The acquisition and disposition of corporations will also be a common triggering event.

Footnotes

1. R&TC §24451 (formerly §§24521 and 24561)
2. R&TC §23051.5(b)(5)
3. R&TC §24451 (formerly §24521)
4. R&TC §24531
5. R&TC §24533
6. R&TC §24533(c)
7. See also MATM 6036
8. R&TC §24990.7 (Senate Bill 1925, Chaptered 90-1349)
9. TreasRegs. §7.367(b)-3(b)
10. Business fixed assets includes all tangible property except inventory.
11. FTB Notice 89-601

Section 19.3 Transactions Within The Scope Of IRC §367(a): Outbound Property Transfers

Contents:

Training Objectives:

As discussed in the introduction, IRC §367 was enacted to limit the tax deferral opportunities available within the nonrecognition provisions of the Code resulting from transfers of property between U.S. persons and foreign corporations. IRC §367 is aimed at maintaining U.S. jurisdiction to tax property transferred to foreign corporations. IRC §367(a) deals specifically with transfers of property to a foreign corporation involved in otherwise nontaxable exchanges. At the end of this section you will be able to:

1) Determine which property transfers fall within the scope of IRC §367(a); and
2) Determine the tax implications to the transferor and the transferee when an otherwise nontaxable property transfer falls within the scope of the provisions of IRC §367(a).

a. General Rules

IRC §367(a)(1) provides the general rule that if a U.S. person transfers property to a foreign corporation in any exchange described by IRC Sections 332, 351, 354, 356, or 361, the foreign corporation will not be considered a corporation for purposes of determining the extent to which gain is recognized as a result of the transfer. Since these enumerated nonrecognition code provisions require corporate status for the exchange to receive nonrecognition treatment, any gain realized **will be recognized** (under §367(a)) unless the transfer falls within an exception contained within §367.

IRC §367(a)(1) applies only to recognize otherwise unrecognized gains from certain transfers of property. It does not apply to transfers which result in otherwise unrecognized losses.[1] In addition, gains recognized as a result of IRC §367 cannot be offset by losses realized under one of the nonrecognition provisions of the Code.

The Code provides that any gain recognized as a result of IRC §367 will not exceed the gain that would have been recognized on a taxable sale of the property.[2] If the gain recognized exceeds this limitation, a proportionate reduction of ordinary and capital gain income is made so that the taxable gain equals the gain that would have been recognized on a taxable sale.[3] The character of the gain (ordinary income vs. capital gain income) is determined as if the transferred property had been disposed of in a taxable exchange.[4] The limitation on the amount of gain recognized applies on an item-by-item basis.

The material that follows explains the impact of §367 on a number of code sections that provide for nonrecognition treatment for of certain transactions. To understand how §367 affects these nonrecognition code sections, you must have a basic understanding of them. See Exhibit 19.3-1 for a summary of these nonrecognition code sections.

b. Transfers Within The Scope Of IRC §367(a)

In order for a transaction to fall within the scope of IRC §367(a), there must be:

1. A transfer of property to a foreign corporation
2. By a U.S. person; and
3. For which a gain is not recognized because the transfer falls within one of the following nonrecognition transactions:
    a. Complete liquidation of a domestic subsidiary into a foreign parent corporation under IRC §332.
    b. The transfer of property by a domestic corporation to a foreign corporation solely in exchange for stock or securities under IRC §351.
    c. Exchanges of stock and securities in certain reorganizations between domestic and foreign affiliates under IRC §354.
    d. Receipt of additional consideration on exchange (so-called "boot") under IRC §354 or §355 between domestic and foreign affiliated corporations under IRC §356.[5]
    e. Distributions, solely of stock or securities in another corporation, pursuant to a plan of reorganization between domestic and foreign affiliates under IRC §361.

Exchanges under IRC §355 previously addressed by the regulations under IRC §367(a) now fall within the scope of Sections §367(b), (c), and (e). In addition, transfers of intangible property under IRC §351 or 361 are specifically addressed by IRC §367(d), rather than by IRC §367(a).[6] Finally, IRC §332 liquidations generally fall within the scope of IRC §367(e).[7]

c. Definitions

The following definitions are relevant to the discussions of outbound transfers under IRC §367(a) and (d).

1. United States Person

The term U.S. person includes those persons described in IRC §7701(a)(30). It also includes a citizen or resident of the U.S., a domestic partnership, a domestic corporation, and any estate or trust other than a foreign estate or trust. An individual electing to be a resident of the U.S. under IRC §6013 (g or h) is treated as a U.S. person while the election is in effect. A nonresident alien or foreign corporation will not be considered a U.S. person because of its actual or deemed conduct of a trade or business within the United States during a taxable year.[8]

2. Foreign Corporation

The term foreign corporation has the meaning set forth in IRC Sections 7701(a)(3), 7701(a)(5), IRC §301.7701-5, and Regulation §301.7701-2.[9] Whether or not a foreign entity should be treated as a corporation is determined in accordance with US tax principles.[10] Refer to the Internal Revenue Code and respective regulations for additional information.

3. Transfer

The term transfer means any transaction that constitutes a transfer for purposes of IRC Sections 332, 351, 354, 355, 356, or 361, as applicable. A cost sharing arrangement described under Regulation §1.482-2(d)(4) or the acquisition of rights to intangible property under such a cost sharing arrangement is not considered a transfer of property described in IRC §367(a)(1).[11] In addition, IRC §367 applies only to transfers, not to loans, leases, licenses or other transactions involving less than full and irrevocable relinquishment by the transferor of all substantial rights in the property.[12]

4. Property

The term property means any item that constitutes property for purposes of IRC Sections 332, 351, 354, 355, 356, or 361, as applicable.[13] A right to enter into executory contracts, or other items that do not rise to a level of valuable proprietary right or interest does not constitute property for purposes of these code sections.

5. Intangible Property

The term intangible property means knowledge, rights, documents, and any other intangible item within the meaning of IRC §936(h)(3)(b) that constitutes property for purposes of IRC Sections 332, 351, 354, 355, 356, or 361, as applicable.[14]

Such property is treated as intangible property for purposes of IRC Sections 367(a) & (d) and the regulations thereunder without regard to whether it is used or developed in the U.S. or in a foreign country and without regard to whether it is used in manufacturing activities or in marketing activities. A working interest in oil and gas properties is not considered to be intangible property for purposes of IRC §367 and the regulations thereunder.[15]

An operating intangible is any intangible property of a type not ordinarily licensed or otherwise transferred in transactions between unrelated parties for consideration contingent upon the licensee's or transferee's use of the property. Examples of operating intangibles may include long-term purchase or supply contracts, surveys, studies, and customer lists.[16]

Foreign goodwill or going concern value is the residual value of a business operation conducted outside of the U.S. after all other tangible or intangible assets have been identified and valued. For purposes of IRC §367 and the regulations thereunder, the value of the right to use a corporate name in a foreign country shall be treated as foreign goodwill or going concern value.[17]

For transfers occurring after December 31, 1983, and before May 16, 1986, foreign trademarks, tradenames, brandnames, and similar marketing intangibles developed by a foreign branch are treated as foreign goodwill or going concern value.[18]

d. Outbound Transfers Of Stock Or Securities

In general, a transfer of stock or securities by a U.S. person to a foreign corporation will usually be subject to §367(a)(1) unless one of the exceptions listed below applies.[19]

1. Transfers Of Domestic Stock Or Securities

A transfer of domestic stock or securities by a US person (directly, indirectly, or constructively) to a foreign corporation is a §367(a) transfer (and subject to gain recognition) if it falls under §351, §354 (pursuant to a reorganization described in §368(a)(1)(B)), or §361(a) or (b). [20]

Gain will not be recognized if domestic corporation complies with the reporting requirements of Treas,Reg. §1.367(a)-3(c)(6) and the following conditions are met:

A. The amount of foreign stock received by the US transferors does not exceed 50% of the total voting power or total value of the foreign corporation,
B. The amount of the foreign transferee's stock owned by "5% target shareholders" and officers or directors of the domestic target immediately after the transfer does not exceed 50% of the voting power or value of the foreign corporation, and
C. The foreign corporation meets the active trade or business requirement (defined in Treas.Reg. §1.367(a)-3(c)(3)) for the 36-month period before the transfer.

If these conditions are met, a shareholder that is not a 5% shareholder (of the foreign corporation) does not have to recognize gain. A 5% shareholder does not have to recognize gain if five-year gain recognition agreement under 1.367(a)-8 is executed.

This regulation (§1.367(a)-3(c)) applies to transactions occurring after 1/29/97. But taxpayers may elect to apply these provisions to transfers occurring after 4/17/94. [21]

2. Transfers Of Foreign Stock Or Securities

For transfers occurring on or after 7/20/98[22], a transfer of foreign stock by a US person to a foreign corporation shall not be subject to §367(a)(1) if the US person is a less than 5-percent shareholder or is a 5-percent shareholder who enters into a gain recognition agreement. [23]

3. Transfers Of Foreign And Domestic Stock, Prior Rules

The rules that apply to transfers of foreign stock occurring before 7/20/98 and transfers of domestic stock occurring before 1/30/97 or 4/17/94[24] can be found at §1.367(a)-3(g).

For transfers of foreign stock during prior periods, §367(a) and its regulations apply modified by the rules contained in §1.367(a)-3(g)(2). For transfers of domestic stock during the prior periods, see the temporary regulation in effect at the time of the transfer and §1.367(a)-3(g)(2).

4. Gain Recognition Agreements

Under certain circumstances described above, a transfer of stock or securities will not be subject to IRC §367(a)(1) if the transferor enters into a gain recognition agreement (GRA).[25] A GRA is a binding agreement where a US shareholder agrees to recognize gain on stock transferred to a foreign corporation if the foreign corporation disposes of the stock within a specified period from the last day of the tax year in which the US person transferred the stock to the foreign corporation.

If a transfer does occur within this specified period, the US person will recognize the gain on an amended return for the year the US person transferred the property to the foreign corporation. The statute of limitations will stay open for this purpose. Information reporting requirements are present.

The regulations provides the rules and guidelines for entering into a gain recognition agreements.

e. Indirect Transfers Subject To §367

The scope of IRC §367(a) is necessarily broad in order to maintain the U.S. jurisdi3ction to tax the U.S. transferor's gain in the property that is being transferred outside the U.S. In addition to providing gain recognition for transactions that directly fall within the scope of IRC §367(a)(1), this section also applies to indirect and constructive transfers as well.[26]

Other property transfers falling within the broad scope of IRC §367(a) include the following types of transfers

1. Forward Triangular Mergers (§368(A)(2)(D)

A U.S. shareholder of a domestic corporation is considered to make a transfer of stock described by IRC §367(a)(1) if the domestic corporation transfers substantially all of its properties to another domestic corporation in a forward triangular merger, and the controlling corporation as described by IRC §368(a)(2)(D) is a foreign corporation.[27]

<u>Example 1</u>:

F, a foreign corporation owns all of the stock of Newco, a domestic corporation. In a forward triangular merger, Newco acquires all of the assets and liabilities of W (a domestic corporation) in exchange for F Corp stock. The F Corp stock is distributed to W's shareholder (A Corp) and W dissolves. The reorganization is considered a transfer of stock described in IRC §367(a)(1) by A.[28] See Exhibit 19.3-2 for a diagram of the transaction.

2. Reverse Triangular Mergers (§368(A)(2)(E)

The U.S. shareholders (A Corp) of a domestic corporation (W Corp) are considered as making an indirect transfer of stock described in Section §367(a)(1) if the domestic corporation (W Corp) acquires substantially all the properties of another corporation (Newco Corp) in a reverse triangular merger, and the controlling corporation (F Corp) is a foreign corporation.[29] See Exhibit 19.3-3 for a diagram.

3. Indirect Transfers: "B" Reorganizations

If a U.S. person exchanges stock in a domestic corporation for voting stock of a foreign corporation in a "B" reorganization, then that U.S. person is considered as making a transfer of stock subject to IRC §367(a)(1).[30]

Example 2:

F, a foreign corporation, owns all the stock of S, a domestic corporation. S acquires all the stock of Y Corp (a domestic corporation) in a "B" reorganization, and Y's shareholder (U Corp) receives stock in F. U Corp (because it is considered a US person) made an indirect transfer of stock described in IRC §367(a)(1).[31] See Exhibit 19.3-4 for a diagram.

4. Indirect Transfers: "C" Reorganizations

A U.S. shareholder of a domestic corporation (Z) is considered as making a transfer of stock subject to IRC §367(a)(1) if Z transfers substantially all of its properties to another domestic corporation (R) in a "C" reorganization, and R receives voting stock in a foreign corporation (F Corp) that is in control of R and distributes that stock to its shareholders (V).[32]

See Exhibit 19.3-5 for a diagram. See Example 5 of §1.1367(a)-3(d)(3) for more information.

5. Indirect Transfers Involving Partnerships And Partnership Interests

A. Transfers By Partnerships

If a partnership (foreign or domestic) transfers property to a foreign corporation that falls within the scope of IRC §367(a)(1), then the partners of the partnership who are U.S. persons shall be treated as having made a direct transfer of their proportionate share of partnership property in a exchange described in IRC §367(a)(1), as determined under the rules and principles of IRC §701-761.[33] A

U.S. person required to recognize gain under the rules of this section is permitted a special basis adjustment.[34]

Example 3:

P is a partnership having five equal partners, two of whom are United States persons. P transfers property to F, a foreign corporation in an exchange described in IRC §351. The exchange includes an indirect transfer of property by the partners to F. The transfer of forty percent of the property is attributable to the partners that are U.S. persons, and is considered a transfer described in IRC §367(a)(1). The gain, if any, recognized on the transfer of 40% of each asset is attributed to the two partners that are US persons.[35]

B. Transfer Of Partnership Interest

If a U.S. person transfers a partnership interest in an exchange described by IRC §367(a)(1), then the person shall be treated as having transferred a proportionate share of the partnership's property as determined under the rules and principles of IRC §701-761 in a transfer described in IRC §367(a)(1).[36] U.S. persons recognizing gain under the rules of this section are permitted a special basis adjustment.[37] The active trade or business exception of IRC §367(a)(1) discussed in Section 19.3(f), Water's-Edge Manual is applied to the underlying partnership property, rather than to the partnership interest.[38]

C. Transfer Of Limited Partnership Interest

A transfer of a limited partnership interest in a U.S. partnership regularly traded on an established securities market is treated as a stock transfer under Regulation 1.367(a)-3.[39]

6. Transfers By Trusts And Estates

As a general rule, a transfer of property by an estate or trust is treated as a transfer by that entity and not as an indirect transfer by its beneficiaries.[40] However, transfers by grantor trusts are treated as a transfer by a U.S. person(s) who is considered the owner of the assets of the trust under IRC Sections 671 through 679. [41]

7. Changes In Classification Of An Entity

Entities may be classified for tax purposes as corporations, partnerships, associations taxable as corporations, etc. When the classification of an entity is changed, there is deemed to be a liquidation or dissolution of the old entity, and a reincorporation or formation of a new entity. For example, if a foreign partnership changes its classification to an association taxable as a corporation, then there will be a deemed IRC §351 transfer of property to the new corporation followed by a dissolution of the partnership (Proposed Treasury Reg. §301.7701-3(g)). These deemed transactions may be subject to the provisions of §367(a).[42]

The reclassification of foreign entities is expected to become much more frequent beginning in 1997 when new federal "check the box" regulations allow taxpayers to elect or change the classification of an unincorporated entity. Taxpayers who make this election are required to attach a copy of a Form 8832 Entity Classification Election to their federal tax or information return in the year of the election. If this form is attached to an income year that you are auditing, determine how the change in classification was reported for California tax purposes and whether §367(a) is applicable to the deemed transactions. For more information regarding the "check the box" rules, see Section 2.9, Water's-Edge Manual.[43]

8. Constructive Transfers Under IRC §1504(d)

A termination of a contiguous country election under IRC §1504(d) will result in a constructive transfer subject to the provisions of IRC §367(a)(1).[44]

<u>Example 4</u>:

Domestic corporation Y previously made a valid election under IRC §1504(d) to have its wholly owned Canadian subsidiary, C, treated as a domestic corporation. C fails to continue to qualify for the election under §1504(d). A constructive reorganization described in IRC §368(a)(1)(D) occurs. The resulting constructive transfer of assets by domestic corporation C to Canadian corporation C upon termination of the election under IRC §1504(d) is a transfer of property described in IRC §367(a)(1).[45]

Section 1504(d) does not apply for California purposes for years beginning on or after 1/1/96.

9. Contributions To Capital

IRC §367(c)(2) and the regulations thereunder set forth the rules with respect to treating a contribution to capital of a foreign corporation as a transfer described in IRC §367(a)(1).[46]

10. Effective Dates Of Rules Relating To Indirect Transfers

The provisions of §1.367(a)-3(d) (relating to indirect transfers in certain reorganizations) apply to transfers occurring on or after July 20, 1998. The rules that applied prior to this date are at 1.367(a)-1T(c)(2) of the Treasury Regulations of 1998. The rules in this temporary regulation are the same as in the permanent regulations. The temporary regulation applies to transfers occurring after June 16, 1986 or December 31, 1984. See §1.367(a)-1T(g) for more information. [47]

The provisions of §1.367(a)-1T(c)(3) (relating to transfers of partnerships or partnership interests) applies to transfers occurring after June 16,1986. The other provisions of this subsection (19.3(e)) apply to transfers occurring after December 31, 1984. [48]

f. Exception To The General Rule Requiring Gain Recognition Under IRC §367(a) For Transfers Of Property For Use In The Active Conduct Of A Trade Or Business

1. In General

The Internal Revenue Code provides for a principal exception to the automatic gain recognition imposed by IRC §367(a) when property is transferred for use in the active conduct of a trade or business in a foreign country. With limited exceptions, IRC §367(a)(1) will not apply when property is transferred for use by the foreign corporation in the active conduct of a trade or business outside the United States, and the U.S. transferor complies with the reporting requirements of IRC §6038B and the regulations thereunder.[49] Assets which produce passive income, such as interest or rent, ordinarily will not satisfy the active trade or business exception, and "tainted assets" are specifically excluded from this exception. (See discussion of tainted assets at Section 19.3(g), Water's-Edge Manual).

To discover whether the transfer meets the requirements for the active trade or business exception, the following factual determinations must be made:

A. What is the trade or business of the transferee?
B. Do the activities of the transferee constitute the active conduct of that trade or business?
C. Is the trade or business conducted outside the United States?
D. Is the transferred property used or held for use in that trade or business?[50]

All of the above listed determinations are subject to a facts and circumstance test when deciding whether the activities of a foreign corporation constitute a trade or business. The rules concerning these four determinations are provided as follows:

A. Trade Or Business

A trade or business is generally defined as a specific unified group of activities that constitute (or could constitute) an independent economic enterprise carried on for profit. To constitute a trade or business, a group of activities must ordinarily include every operation, which forms a part of, or a step in, a process by which an enterprise may earn income or profit. One or more of such activities may be carried on by independent contractors under the direct control of the foreign corporation so long as it meets the active conduct test described by Regulation §1.367(a)-2T(b)(3).[51]

Any activity giving rise to expenses that could be deductible only under IRC §212 (expenses for the production of income) if the activities were carried on by an individual, or the holding for one's own account of investments in stock, securities, land, or other property, including casual sales thereof, considered alone, do not constitute a trade or business.[52]

B. Active Conduct

In general, a corporation actively conducts a trade or business only if the officers and employees of the corporation carry out substantial managerial and operational activities. A corporation may be engaged in the active conduct of a trade or business even though incidental activities of the trade or business are carried out on behalf of the corporation by independent contractors. While the activities of independent contractors are not considered in determining whether the officers and employees of the corporation carry out substantial managerial and operational activities, the activities of officers and employees of related entities who are made available to, and are supervised on a day-to-day basis by, the transferee foreign corporation are considered.[53]

Whether a trade or business producing rents or royalties is actively conducted is determined under the principles of Regulation §1.954-2(d)(1).[54]

C. Outside Of The United States

Generally, the primary managerial and operational activities of the trade or business must be conducted outside the United States. In addition, immediately after the transfer the transferred assets must be located outside the United States. The transfer of domestic business assets to a foreign corporation would not be subject to this exception if the domestic business continued to operate in the U.S. after the transfer.[55]

D. Use In The Trade Or Business

Generally, property is considered used or held for use in a foreign corporation's trade or business if it is:

1. Held for the principal purpose of promoting the present conduct of the trade or business;
2. Acquired and held in the ordinary course of the trade or business; or
3. Otherwise held in a direct relationship to the trade or business. Property is considered held in a direct relationship to a trade or business if it is held to meet the present needs of that trade or business and not its anticipated future needs.[56]

2. Property Subsequently Transferred By Transferee
<u>CORPORATION</u>

If a foreign corporation receives property in an exchange described by IRC §367(a)(1) and as part of the same transaction transfers the property to another person, then the active trade or business exception will not apply unless:

A. The initial transfer is followed by one or more subsequent transfers described in IRC §351 or §721; and
B. Each subsequent transferee is either a partnership in which the preceding transferor is a general partner or a corporation in which the preceding transferor owns common stock; and
C. The ultimate transferee uses the property in the active conduct of a trade or business outside the United States.[57]

Transfers within 6 months of the initial transfer will be considered "part of the same transaction". Transfers after this six-month period may be considered "part of the same transaction" if the step-transaction principles apply.

3. Special Rules For Certain Property

The Regulations provide for special rules for determining the applicability of IRC §367(a)(1) to specific property transfers. The treatment of any property described in that section are controlled exclusively under the rules of that section.[58]

A. Depreciated Property Used In The U.S.

If a U.S. person transfers U.S. depreciated property to a foreign corporation in an exchange described by IRC §367(a)(1), then the U.S. person will include in its gross income for the taxable year in which the transfer occurs ordinary income equal to the gain that would have been includible in the transferor's gross income under IRC Sections 617(d)(1), 1245(a), 1250(a), 1252(a), or 1254(a), whichever is applicable, as if the transferor had sold the property at its fair market value. Depreciation recapture is required regardless of whether any exception under IRC §367(a)(1) applies.[59]

U.S. depreciated property subject to this rule includes mining property; IRC §1245 property; IRC §1250 property; farm land; or oil, gas or geothermal property, used in the U.S., or qualified as IRC §38 property by virtue of IRC §48(a)(2)(B) prior to its transfer.[60] For property used both within and without the U.S., the amount of required depreciation recapture is determined by the ratio of U.S. use to total use multiplied by the full recapture amount.[61] This rule is effective for transfers occurring on or after June 16, 1986.[62]

B. Property To Be Leased By The Transferee

Tangible property transferred to a foreign corporation that will be leased to other persons by the foreign corporation will be considered to be transferred for use in the active conduct of a trade or business outside of the U.S. only if:

- The transferee's leasing of the property constitutes the active conduct of a leasing business;
- The property is not used or expected to be used by the lessee in the U.S.; and,
- The transferee has need for substantial investment in assets of the type transferred. [63]

The active conduct of a leasing business requires that the employees of the foreign corporation perform substantial marketing, customer service, repair and

Maintenance, and other substantial operational activities with respect to the transferred property outside of the U.S.[64] Real property located outside the U.S. is also subject to this rule.

C. Property To Be Sold

Property is not considered used in the active conduct of a trade or business if, at the time of the transfer, it is reasonable to believe that in the reasonably foreseeable future, the transferee will sell or otherwise dispose of the property other than in the ordinary course of business.[65]

D. Compulsory Transfers

Property is presumed to be transferred for use in the active conduct of a trade or business outside the U.S. if:

- The property was previously in use in the country in which the transferee foreign corporation is organized; and
- The transfer is either legally required by the foreign government or compelled by a genuine threat of immediate expropriation.[66]

E. Other Special Rules

The Regs. provide for special rules for oil and gas working interests, and transfers to foreign sales corporations.[67] Refer to the regulations for more information.

g. Tainted Assets

IRC §367(a)(3)(B) provides that certain property transfers cannot qualify for the active conduct of a trade or business exception. In addition, a transfer of "tainted assets" is subject to IRC §367(a)(1) even if the transfer is a compulsory transfer described in Regulation §1.367(a)-4T(f).[68]

Tainted assets include:

1. Inventory, etc.

Raw materials, supplies, partially completed goods, and finished products are considered inventory for purposes of this section.[69] In addition, certain copyright, literary, musical, or artistic composition, letter or memorandum, and similar property will be treated as tainted assets.[70]

2. Installment Obligations, Accounts Receivable, and Similar Property

To the extent the principal amount of such property has not previously been included in income, these assets are considered tainted property.[71]

3. Foreign Currency or Other Property Denominated in Foreign Currency

Foreign currency and other property denominated in foreign currency, including installment obligations, futures contracts, forward contracts, accounts receivable, or any other obligation entitling its payee to receive payment in a currency other than U.S. dollars is considered property subject to the provisions of IRC §367(a)(1).[72] There are special exceptions to this provision, including the allowance of netting of gains and losses realized as part of the same transaction.[73]

4. Intangible Property

A transfer of intangible property (other than foreign goodwill or going concern value) in an IRC §332 liquidation is always subject to IRC §367(a)(1).[74] Refer to Section 19.6, Water's-Edge Manual, Transfers of Intangible Property to a Foreign Corporation Under IRC §367(d), for more information on the treatment transfers of intangible property in §351 or §361 transactions.

5. Leased Tangible Property

IRC §367(a)(1) applies to a transfer of tangible property with respect to which the transferor is a lessor at the time of the transfer. In such instances, the transfer will be treated as a transfer of tainted assets, unless:

- with respect to property that will not be leased by the transferee to third persons, the transferee was the lessee of the property at the time of the transfer; or
- with respect to property that will be leased by the transferee to third persons, the transferee satisfies the active leasing business or de minimis tests.[75]

h. Recapture Of Branch Losses

1. In General

The Regulations provide an exception to gain recognition under IRC §367(a)(1) for assets transferred for use in the active conduct of a trade or business outside the U.S. However, the active trade or business exception does not apply to any assets of a foreign branch transferred to a foreign corporation. For such transfers, the transferor recognizes a gain equal to the sum of the previously deducted branch losses (ordinary and capital).[76]

2. Definitions

The following definitions are relevant to the discussion of the branch loss recapture rules.

A. Foreign Branch

For purposes of IRC §367(a)(3)(c), the term "foreign branch" means an integral business operation carried on by a U.S. person outside the United States. Whether the activities of a U.S. person constitute a foreign branch operation must be determined based on all facts and circumstances.[77]

B. Branch Assets

Branch assets include any foreign goodwill, going-concern value, and intangible property for purposes of computing the gain limitation. [78]

3. Rules Regarding Gain Recognition

Regulation §1.367(a)-6T(c) provides special rules concerning gain recognized under the branch loss recapture rules. Specifically, the recapture of previously deducted branch ordinary losses is treated as ordinary income, and the recapture of previously deducted branch capital losses are treated as capital gain income. The gain recognized is treated as foreign-sourced income for federal purposes.

A. Amount Of Branch Loss Recapture

The amount of branch loss recapture required is equal to the sum of previously deducted branch ordinary loss for each branch loss year reduced by expired net ordinary losses, and the previously deducted branch capital loss for each loss year reduced by expired net capital losses.[79] This amount is reduced, proceeding from the first branch loss year to the last branch loss year, to reflect expired foreign tax credits and expired investment credits. In addition, the previously deducted losses are reduced by any taxable income of the foreign branch recognized through the close of the taxable year of the transfer. Finally, the previously deducted branch losses are reduced by any gain recognized under IRC §367(a)(1)(other than by reason of this provision) upon transfer of the assets of the foreign branch to the foreign corporation.[80]

The computation of the branch loss recapture amount is done on a branch-by-branch basis if more than one branch is being transferred to a foreign corporation. One branch's gains cannot be used to offset another branch's losses.

B. Anti-Abuse Rule

Regulation §1.367(a)-6T(h) provides that if a U.S. person transfers property of a foreign branch to a domestic corporation for the principal purpose of avoiding the effect of the foreign branch loss recapture provision, and the domestic corporation thereafter transfers the property of the foreign branch to a foreign corporation, then, solely for purposes of this section, the U.S. person will be treated as having transferred the property of the branch directly to the foreign corporation.

A principal purpose of avoiding the branch loss recapture rule is presumed if the domestic corporation transfers the property within two years of receiving it from a foreign branch. This presumption can be rebutted by clear evidence that the second transfer was not contemplated at the time of the first, and that the avoidance of the branch loss recapture rule was not a principal purpose of the transfer.

i. Transactions Specifically Not Affected By IRC §367(a)

IRC §367(a) does not apply unless the transaction in question is specifically identified by this section. Specifically, the following exchanges are not affected by IRC §367(a):

1. One month liquidations under IRC §333 (Repealed for liquidations occurring after July 31, 1986, unless the corporation is completely liquidated by January 1, 1987);[81]
2. Like-kind exchanges described by IRC §1031;
3. 3. Exchange of money or property for shares of a corporation's stock described in IRC §1032;
4. Exchange of stock of the same class for other stock of that class under IRC §1036;
5. A transfer where a loss is generated;
6. Reorganizations involving U.S. companies when the shareholder is a foreign corporation.
7. A transfer of appreciated property by a foreign corporation to a U.S. subsidiary.
8. Exchanges where all parties involved are foreigners.

j. Summary

IRC §367(a) limits the availability of gain nonrecognition under certain provisions of the Code. In many instances, gain recognition under IRC §367(a)(1) can be avoided by entering into a gain recognition agreement. The transactions that fall within the scope of IRC §367(a) can be very simple or intricately complex. This discussion has deliberately been limited to discussing IRC §367(a) in its most simplified state. For detailed discussions of IRC §367(a) transactions, refer to the following article:

The New Section 367 Regulations (Oct. 1998) Journal of International Taxation , page 11.

Footnotes

1. TreasRegs. §1.367(a)-1T(b)(1)
2. TreasRegs. §1.367(a)-1T(b)(3)(i)
3. TreasRegs. §1.367(a)-1T(b)(3)(iii)
4. TreasRegs. §1.367(a)-1T(b)(4)(i)(A)
5. Although IRC §367(a) refers to IRC §355 transactions, IRC §367(a) is not what triggers gain recognition for an IRC §355 transaction because corporate status of the transferee is not required to obtain nonrecognition treatment. Instead, IRC §367(e) specially controls transactions within the scope of IRC §355.
6. IRC §367(d)(1)
7. TreasRegs. §1.367(e)-2T(a)(2)
8. TreasRegs. §1.367(a)-1T(d)(1)
9. TreasRegs. §1.367(a)-1T(d)(2)
10. Rev.Rul, 88-8, 1988-1 CB 403
11. TreasRegs. §1.367(a)-1T(d)(3)
12. Revenue Ruling 69-156, 1969-1 CB 101
13. TreasRegs. §1.367(a)-1T(d)(4)
14. TreasRegs. §1.367(a)-1T(d)(5)(i)
15. TreasRegs. §1.367(a)-1T(d)(5)(i)
16. TreasRegs. §1.367(a)-1T(d)(5)(ii)
17. TreasRegs. §1.367(a)-1T(d)(5)(iii)
18. TreasRegs. §1.367(a)-1T(d)(5)(iv)
19. TreasReg. §1.367(a)-3(a)
20. TreasReg. §1.367(a)-3(c)
21. TreasReg. §1.367(a)-3(c)(11)
22. TreasReg. §1.367(a)-3(e)
23. TreasReg. §1.367(a)-3(b)
24. TreasReg. §1.367(a)-3(e)
25. TreasReg. §1.367(a)-8
26. TreasRegs. §1.367(a)-1T(c)(1)
27. TreasRegs. §1.367(a)-3(d)(1)(I)
28. TreasRegs. §1.367(a)- 3(d)(1)(3), example 1
29. TreasRegs. §1.367(a)- 3(d)(1)(ii)
30. TreasRegs. §1.367(a)- 3(d)(1)(iii)
31. TreasRegs. §1.367(a)- 3(d)(1)(3), example 4
32. TreasRegs. §1.367(a)- 3(d)(1)(v)
33. TreasRegs. §1.367(a)-1T(c)(3)(i)(A)

34. TreasRegs. §1.367(a)-1T(c)(3)(i)(B)
35. TreasRegs. §1.367(a)-1T(c)(3)(i)(Example)
36. TreasRegs. §1.367(a)-1T(c)(3)(ii)(A)
37. TreasRegs. §1.367(a)-1T(c)(3)(ii)(B)
38. TreasRegs. §1.367(a)-1T(c)(3)(ii)
39. TreasRegs. §1.367(a)-1T(c)(3)(ii)(C)
40. TreasRegs. §1.367(a)-1T(c)(4)(i)
41. TreasRegs. §1.367(a)-1T(c)(4)(ii)
42. TreasRegs. §1.367(a)-1T(c)(6)
43. CCR §§ 23038(b)-1, 23038(b)-2, and 23038(b)-3
44. TreasRegs. §1.367(a)-1T(c)(5)
45. TreasRegs. §1.367(a)-1T(c)(5)(Example)
46. TreasRegs. §1.367(a)-1T(c)(7)
47. TreasReg. §1.367(a)-3(e)
48. TreasRegs. §1.367(a)-1T(g)
49. TreasRegs. §1.367(a)-2T(a)
50. TreasRegs. §1.367(a)-2T(b)
51. TreasRegs. §1.367(a)-2T(b)(2)
52. TreasRegs. §1.367(a)-2T(b)(2)
53. TreasRegs. §1.367(a)-2T(b)(3)
54. TreasRegs. §1.367(a)-2T(b)(3)
55. TreasRegs. §1.367(a)-2T(b)(4)
56. TreasRegs. §1.367(a)-2T(b)(5)
57. TreasRegs. §1.367(a)-2T(c)(2)
58. TreasRegs. §1.367(a)-4T(a)
59. TreasRegs. §1.367(a)-4T(b)(1)
60. TreasRegs. §1.367(a)-4T(b)(2)
61. TreasRegs. §1.367(a)-4T(b)(3)
62. TreasRegs. §1.367(a)-4T(b)(5)
63. TreasRegs. §1.367(a)-4T(c)(1)
64. TreasRegs. §1.367(a)-4T(c)(1)
65. TreasRegs. §1.367(a)-4T(d)
66. TreasRegs. §1.367(a)-4T(f)
67. TreasRegs. §1.367(a)-4T(e)&(h)
68. TreasRegs. §1.367(a)-5T(a)
69. TreasRegs. §1.367(a)-5T(b)(1)
70. TreasRegs. §1.367(a)-5T(b)(2)
71. TreasRegs. §1.367(a)-5T(c)
72. TreasRegs. §1.367(a)-5T(d)(1)

73. TreasRegs. §1.367(a)-5T(d)(2)
74. TreasRegs. §1.367(a)-5T(e)
75. TreasRegs. §1.367(a)-5T(f)
76. TreasRegs. §1.367(a)-6T(a)
77. TreasRegs. §1.367(a)-6T(g)
78. TreasRegs. §1.367(a)-6T(c)(3)&(4)
79. Expired net operating losses and capital losses are losses that were carried forward by the taxpayer in anticipation of offsetting future operating income and capital gains income. However, the losses were never utilized.
80. TreasRegs. §1.367(a)-6T(d)&(e)
91. P.L. 99-524, Sec. 631(e)(3)

Section 19.4 Other Property Transfers: IRC §367(b)

Contents:

Training Objectives:

The scope of IRC §367 is intended to be extremely broad. Similar to IRC §367(a), IRC §367(b) focuses on requiring gain recognition for specific transfers under specific provisions of the Code that otherwise provide that gain recognition is not required. However, unless the transfer is specifically addressed by the regulations under IRC §367(b), nonrecognition treatment under the applicable Code section is allowed. At the end of this section you will be able to:

1) Determine which transfers fall within the scope of IRC §367(b); and
2) Determine the tax implications to the transferor and the transferee when a transfer falls within the provisions of IRC §367(b).

a. In General

IRC §367(b) is aimed at preventing tax avoidance on foreign-to-foreign transfers, and transfers of assets <u>into</u> the U.S. taxing jurisdiction regardless of whether the avoidance was intentional or not. As a general rule under IRC §367(b), inbound transfers will result in gain recognition while foreign-to-foreign exchanges will not. In the case of foreign-to-foreign transfers, the main tax avoidance concern of the statute and regulations is circumvention of IRC §1248.[1]

Note: We have not conformed to IRC §1248. However, California law §24451 incorporates federal §367, and that section provides that certain computations should be made using the principles of §1248. Although we can not tax amounts that are included in income under §1248, we do apply §1248 principles to the extent authorized under §367. See Section 19.2(b), Water's-Edge Manual.

Internal Revenue Code §367(b) does not apply to any transaction to the extent the foreign corporation fails to be treated as a corporation by reason of IRC §367(a)(1).[2] However, if IRC §367(a)(1) applies to only a portion of the transaction, IRC §367(b) may apply to the remaining portion of the transaction. In addition, IRC §367(b) does not provide for automatic gain recognition on otherwise tax-free exchanges. Instead, IRC §367(b) specifies by regulation which inbound transfers or foreign-to-foreign transfers will result in gain recognition if the transaction otherwise falls within the scope of one of the nonrecognition provisions of the Code. If the transfer is not described in the regulations, IRC §367(b) does not apply. Similar to IRC §367(a), IRC §367(b) is applicable only to exchanges that require corporation status in determining the extent to which gain is recognized.

<u>Example 1:</u>

IRC §367(b) does not apply to transfers of property by a foreign corporation to a U.S. corporation under IRC §351 since corporate status of the transferor is not relevant for IRC §351 purposes. Only the transferee is required to be a corporation for purposes of IRC §351.

Internal Revenue Code §367(b) provides that in the case of any exchange described in IRC Sections 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer described in IRC §367(a)(1), a foreign corporation will be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of federal income tax. The explanation accompanying the IRC §367(b) regulations provides that where they are silent with respect to a specific exchange, the appropriate Code sections (which provides for nonrecognition of gain) will apply without modification.[3]

The §367(b) regulations generally seek to preserve the IRC "§1248 amount" that would have been recognized as dividend income had there been a taxable disposition of CFC stock. Accordingly, IRC §367(b) will generally have no application to the acquisition or disposition of stock or assets of a foreign corporation that was not a CFC (as defined in IRC §957) within the five-year period preceding the exchange.

Depending on the identity of the exchanging shareholder and the character of the stock received by the exchanging shareholder in the transaction, essentially three alternative consequences could follow under IRC §367(b):

1. The U.S. shareholder, if it is the exchanging shareholder in a transaction in which it receives other than CFC stock, may be required to currently include in gross income a prescribed amount as income;
2. The U.S. shareholder, if it is the exchanging shareholder in a transaction in which it receives CFC stock, may be permitted to defer the otherwise applicable gain recognition, subject to certain conditions, under the special attribution rules providing for the recognition of gain to such U.S. shareholder on a later sale or other disposition of the stock received; or
3. The U.S. shareholder, if it is not the exchanging shareholder, will not be subject to gain recognition; however, the earnings and profits (or deficit in earnings and profits) of the exchanging foreign corporation must be appropriately increased, and such U.S. shareholder may, in order to obtain an increase in the basis of the stock received by such corporation, have to consent to treat the increase as a dividend to the exchanging foreign corporation.

The complex rules established by IRC §367(b) and the regulations thereunder apply only to U.S. shareholders and CFC's. The transfers subject to gain recognition under IRC §367(b) are specifically outlined by the regulations.

b. Definitions

A number of terms are used in Section 367(b) and in related provisions. These terms are listed and defined in Exhibit 19.4A. You may find it easier to remove these pages from the binder and refer to them when you encounter an unfamiliar term rather than flipping back and forth.

c. Liquidations Subject To A Gain Recognition Under IRC §367(b)

1. Liquidation Of A Foreign Corporation Into A Domestic Parent Under IRC §332

Liquidations under IRC §332 involve the distribution of property to a parent corporation in complete cancellation of the stock of an 80% or more owned subsidiary. When liquidating a foreign subsidiary into a domestic parent two possible situations could arise:

A. A domestic corporation could receive a distribution in complete liquidation of a foreign subsidiary, include the "all earnings and profits amount" attributable to its stock in the distributing foreign corporation in its gross income (as a deemed dividend), and comply with the reporting requirements. The dividend is deemed to have been made in money immediately before the transaction. In such an instance, the foreign corporation would be considered a corporation for purposes of all relevant Code provisions.[4] The "all earnings and profits amount" would be treated as dividend income under §301[5] subject to the IRC §902 foreign tax credit provisions.[6] The "all earnings and profit" is also treated as a dividend for California purposes. See part 6 of Section 19.2(b), Water's-Edge Manual.

<u>Example 2:</u>

Corporation D, a U.S. corporation, owns 100% of the stock of Corporation F, a foreign corporation. Corporation F has pre-1963 earnings and profits of $1 million, and post-1962 earnings and profits of $4 million. Corporation D liquidates Corporation F and realizes a gain of $6 million in the exchange. If Corporation D includes the "all earnings and profits amount" of $5 million in income, Corporation F will be considered a corporation for purposes of IRC §332.

B. The domestic corporation could fail to include the "all-earnings and profits" amount in its gross income. For purposes of determining the extent to which gain or loss is recognized, the foreign corporation would not be considered a corporation for purposes of IRC §332. However, the foreign corporation will be considered a corporation for purposes of all other code provisions, such as §331 and §334. As a result, gain to the domestic shareholder would be determined under IRC §331. IRC §1248 would apply to recharacterize all or a portion of the gain recognized by the U.S. parent as a dividend. The remainder, if any, would be taxed as capital gains income. Basis to the parent would carry-over under IRC §334(b)(1).[7] Finally, any amounts included in income as deemed dividends under IRC §1248 are treated as previously taxed income under IRC §959(e) when distributed.

Note: It is unclear whether §336 would apply to the liquidating corporation.[8]

Example 3:

Corporation A, a U.S. corporation owns 100% of the stock of Corporation B, a foreign corporation. Corporation B has pre-1963 earnings and profits of $1 million, and post-1962 earnings and profits of $3 million. Corporation A liquidates Corporation B and realizes a gain of $6 million in the exchange. Corporation A does not include the all earnings and profits amount of $4 million in income. Corporation A must include post-1962 earnings and profits of $3 million as ordinary income under IRC §1248. The remaining $3 million in realized gain is treated a capital gain income. Corporation A will hold Corporation B's assets at a carry-over basis as provided by IRC §334(b)(1).

For California purposes, IRC §1248 would not apply (outside the window period), so the entire $6 million would be capital gain income. The reason §1248 does not apply here is because §367 only requires gain recognition (for both California and federal purposes). Reclassification of the gain as a dividend is required under §1248, not §367, so California does not pick up that reclassification.

2. Indirect Liquidations Of A Foreign Corporation Into A Domestic Parent

A US shareholder (which is a domestic corporation) must include in income the all- earnings-and-profits amount of the foreign subsidiary in a reorganization where

- The assets of the foreign corporation are acquired by a domestic corporation in a Type §368(a)(1)(C), (D), or (F) reorganization, and
- The US shareholder receives stock of the acquiring domestic corporation in exchange for its stock in the foreign corporation.[9]

The amount included in income is treated as a dividend paid in money immediately before the exchange.
(§7.367(b)-3(b))

3. Liquidation Of A Foreign Corporation Into A Foreign Parent Under IRC §332

If a foreign corporation liquidates into another foreign corporation, there are no immediate tax consequences. Rather, the liquidating foreign corporation will be treated as a corporation for purposes of IRC §332 and other applicable codes sections[10] so long as the foreign corporation meets the notice requirements of IRC §6038B.[11]

d. Reorganizations Subject To A Gain Recognition Under IRC §367(b)

The effect of an exchange described in IRC §354 or 356 solely for stock or securities in a corporation (other than a foreign investment company defined in IRC §1246(b)) which is a party to the reorganization described in IRC §368(a)(1)(B) through (F) depends on the type of stock exchanged, and whether the U.S. shareholder will remain a U.S. shareholder after the exchange.

Note: When referring to reorganizations in the rest of the chapter, the "§368(a)(1)" will be dropped.

1. Receipt Of Stock In A CFC

If an exchanging shareholder receives stock in a CFC in a Type B, C, or D reorganization , then the attribution-of-earnings- and-profits rules will apply,[12] and no gain or loss will be recognized, if immediately after the exchange:

A. The exchanging shareholder is a U.S. shareholder of that CFC; or
B. All U.S. shareholders of the exchanging foreign corporate shareholder are U.S. shareholders of the CFC.[13]

The earnings and profits of the corporation whose stock is received in the exchange must be increased by the amount of the earnings and profits of the exchanged corporation and any lower-tier subsidiaries of the exchanged corporation. The acquiring corporation does not succeed to any other items under IRC §381(c) unless it is the acquiring corporation within the meaning of IRC §381.[14] The earnings and profits of the exchanged corporation and any lower tier subsidiaries must be reduced to the extent they increased the earnings and profits of the corporation whose stock was received.[15]

For exchanges on or after March 3, 1989, earnings and profits will not require these adjustments if more than 50 percent of either the total voting power or the total voting stock of both the corporation whose stock is exchanged or the corporation whose stock is received is owned by a U.S. shareholder described in Treas. Reg. §7.367(b)-7(b). Rather the attribution of earnings and profits will be determined under IRC §381(a).[16]

As a final note, the basis of the stock of lower-tier subsidiaries of the acquired corporation will require adjustment to reflect any upward flow of earnings and profits.[17]

2. Receipt Of Other Stock

The rule listed below applies to reorganizations in which

A. stock of a foreign corporation is transferred
   - by a U.S. shareholder, or
   - by another CFC (but only if both the CFC and the transferred foreign corporation have the same U.S. shareholder); and

B. the exchanging shareholder receives
   - stock of a domestic corporation,
   - stock of a foreign corporation which is not a CFC, or
   - stock of a CFC (provided none of the U.S. shareholders of the foreign corporation whose stock is being transferred are U.S. shareholder of the CFC).

If this criteria is met, then either of the following will occur:

A. If the exchanging shareholder is a U.S. shareholder, the shareholder will include in gross income the "IRC §1248 amount" attributable to the transferred foreign stock, to the extent the fair market value of the stock exchanged exceeds its adjusted basis; or

B. If the exchanging shareholder is a foreign corporation, it will add to its earnings and profits
   - the "IRC §1248(c)(2) amount" and
   - the "additional earnings and profits amount" of the transferred corporation computed as if all the stock of this corporation was owned by the U.S. shareholder.[18] This amount is not treated as a dividend.

Special rules apply to certain exchanges, including amounts attributable to stock in a foreign investment company. A discussion of these rules is beyond the scope of this manual. Please refer to the regulations for additional information.

3. Exchange Of Stock By Certain Domestic Corporations

The "all earnings and profit" amount of an exchange described in IRC §354 will be included in gross income of a U.S. person if:

A. Assets of a foreign corporation were acquired by a domestic corporation in a Type C, D, or F reorganization (This would include an election to treat a foreign corporation incorporated in a contiguous country as a domestic corporation under §1504(d). This election is treated as an IRC §368(a)(1)(F) reorganization under the Code);
B. The exchanging U.S. person is a domestic corporation; and
C. The U.S. person receives stock of a domestic corporation in exchange for its stock in the acquired corporation.[19]

If the domestic corporation does not include the all "earnings and profits" amount in income, the foreign corporation will not be considered a corporation for purposes of determining the extent to which gain is recognized on the exchange. However, except for IRC §354 or §356, all other applicable provisions of the code shall apply as if the foreign corporation was considered a corporation. For example, IRC Sections 358, 362, and 381, if applicable, would apply as if no gain had been recognized (i.e., the U.S. person would obtain a carryover basis in the acquired stock or assets).[20]

4. Reorganizations Involving Foreign Investment Companies

An exchange described in IRC §354 or §356 pursuant to a Type (B), (C),(D), or (F) reorganization involving the acquisition of a foreign investment company (as defined in IRC §1246(b)) where the exchanging shareholder receives stock in a foreign corporation does not require automatic gain recognition under IRC §367(b).[21] However, the reporting requirements under IRC §367(b) must be satisfied.[22] IRC §1246(c) would apply to provide that the stock received in the exchange is treated as foreign investment company stock that was held throughout the period the stock surrendered was held.[23]

Reorganizations where the taxpayer receives stock of a domestic corporation in exchange for stock of a foreign investment company requires the inclusion in income of the "IRC §1246 amount" attributable to the stock of the foreign investment company.[24]

Generally, the "IRC §1246 amount" reportable is equal to the excess of the fair market value of such stock over its adjusted basis.[25] However, if the exchange is a Type (C), (D), or (F) reorganization, involving the acquisition of assets of a foreign investment company, the exchanging shareholder must include in income the "all earnings and profits amount" with respect to that stock computed in accordance with the principals of IRC §1246.[26] The reporting requirements enumerated by IRC §367(b) must also be satisfied.

Failure to include the appropriate adjustment in income will result in the foreign corporation not being considered a corporation for purposes of the nonrecognition provisions of the Code. With respect to any amount included in income as a result of IRC §1246, these amounts are not treated as dividend income, are not subject to the IRC §902 foreign tax credit, and do not require income to be grossed-up under IRC §78.

e. Incorporations -- §351

Regulation §7.367(b)-8 applies to transfers of property by a foreign corporation under IRC §351. If the foreign corporation transfers property under IRC §351 in a transfer also described in IRC §361, Regulation §7.367(b)-8 will apply so long as the transferor remains in existence immediately after the transaction.[27]

If the asset transferred in a §351 exchange is CFC stock, Regulation §7.367(b)-7(c)(ii) will apply to attribute the "IRC §1248 amount", the "IRC §1248(c)(2) amount", the "all earnings and profits amount", and the "additional earnings and profit amount" of the transferred corporation to the foreign corporation. A basis adjustment for the IRC §1248(c)(2) amount requires a consent dividend.[28]

IRC §367(b) will not apply (except for the transfers described in the above two paragraphs) to other §351 transfers since corporation status is not required for nonrecognition treatment under IRC §351.

f. Distribution Of Stock Described IRC § 355

Foreign-to-foreign and inbound distributions of stock and securities of a controlled corporation described in IRC §355 fall within the scope of IRC §367(b). Treatment of the distribution varies depending on the parties to the transaction.

1. Distribution By A Domestic Corporation

If a domestic corporation distributes stock in a CFC, IRC §1248(f) will apply (for federal purposes) to require inclusion in the distributing corporation's income an amount equal to the CFC's post-1962 Section 1248 earnings and profits, to the extent the fair market value of the CFC's stock exceeds the distributing corporation's basis in the stock.[29] The §1248(f) amount will be treated as a dividend. The IRC §1248(f)(2) exception relating to certain distributions of CFC stock to a domestic corporation does not apply to an IRC §355 spin-off transaction.[30] For more information, refer to Treas. Regs. §7.367(b)-10(b).

IRC §1248 usually will not apply for state purposes. See Part 6 of Section 19.2(b), Water's-Edge Manual.

2. Distribution By A Foreign Corporation

If a foreign corporation with at least one U.S. shareholder distributes stock in another corporation, the regulations attempt to preserve the U.S. income tax on the §1248 earnings and profits of the distributing corporation at the U.S. shareholder level. The IRC §1248 tax attributes of the distributing CFC are allocated between the stock retained and the stock exchanged.[31] For details on how to allocate the IRC §1248 tax attributes, refer to Treasury Regulation §7.367(b)-10(d) through (j).

3. Receipt Of Other Stock

If an exchanging U.S. shareholder receives stock of a domestic corporation, stock in a foreign corporation that is not a CFC, or stock of a CFC as to which the exchanging corporation is not a U.S. shareholder, then either:

A. The U.S. shareholder will include in income the excess of "the IRC §1248 amount" over the "IRC §1248 amount" attributed to the stock under Treas. Regs. §7.367(b)-10(h) to the extent of gain (gain is defined as the excess of the fair market value of stock in the distributing corporation owned by the shareholder prior to the distribution over its adjusted basis);[32] or
B. The exchanging foreign corporation shall add to its earnings and profits the excess of the IRC §1248(c)(2) amount computed under Treas. Regs. §7.367(b)-10(g) over the IRC §1248(c)(2) amount attributed to stock under Treas. Regs. §7.367(b)-10(h).[33] The amount included in income under IRC §1248(c)(2) is not treated as a dividend.

In all situations to which Treas. Reg. §7.367(b)-10 applies, the reporting requirement of IRC §6038B must be satisfied as well.

g. Notice Requirements

The notice requirements of the temporary regulations are easily overlooked. The regulations provide for specific reporting requirements for transactions subject to IRC §367(b).[34] A taxpayer's failure to fulfill the notice requirements will constitute a failure to comply with the conditions established by the Regulations. If the taxpayer does not establish reasonable cause, the IRS can disregard the regulations, disregard corporate status, and tax the taxpayer on the transaction.

The Regulations provide that if any person required to file an income tax return realized gain or other income on account of any exchange to which IRC §367(b) applies, regardless of whether the income is recognized or not, then that person must file a notice of such exchange on or before the last date for filing a Federal income tax return for the person's taxable year in which gain or other income is realized. This notice must be furnished to the district director with whom the person would be required to file Federal income tax return.[35]

The information required to be filed with the district director includes:

1. A statement that the exchange is one to which IRC §367(b) applies;
2. A complete description of the exchange;
3. A description of any stock or securities received in the exchange;
4. A statement which describes any amount required, under Regulation §7.367(b)-4 through §7.367(b)-12, to be included in gross income or added to the earnings and profits or deficit of an exchanging foreign corporation for the person's taxable year in which the exchange occurs;
5. A statement which describes any amount of earnings and profits attributed by reason of the exchange, under Regulation §7.367(b)-4 through §7.367(b)-12, to stock owned by any U.S. person.
6. Any information which is or would be required to be furnished with a Federal income tax return pursuant to Regulations under IRC Sections 332, 351, 354, 355, 356, 361, or 368, regardless of whether a Federal income tax return is required to be filed;
7. Any information required to be furnished under IRC §6038 or §6046 if such information has not otherwise been provided.[36]

h. Failure To Comply

If a taxpayer with a reporting requirement under IRC §367(b) fails to comply with the regulations, the Commissioner will make a determination whether a foreign corporation will be considered to be a corporation based on all the facts and circumstances surrounding the failure to comply. In making this determination the Commissioner may conclude that:

1. the foreign corporation will be considered to be a corporation despite the failure to comply;
2. the foreign corporation will be considered to be a corporation provided that it complies with the conditions imposed under Regulation §7.367(b)-4 through §7.367(b)-12; or
3. the foreign corporation will not be considered to be a corporation only for purposes of determining the extent to which gain shall be recognized, but with a step-up in basis allowed in the amount of the gain recognized.

This could result in the gain being recognized when it could have otherwise deferred had the taxpayer not overlooked the notification requirements in the regulations.[37]

i. Characterization Of Amounts Included In Income Of An Exchanging U.S. Shareholder

1. Amounts Computed Under The Principles Of IRC §1248

The regulations provide that any amount included in income computed under the principles of IRC §1248 (e.g., "the all earnings and profits amount") as a result of IRC §367(b) is treated as a dividend paid in cash immediately prior to the exchange taxable under IRC §301.[38] This amount is subject to the IRC §902 foreign tax credits in the same manner as if they were actually distributed as a dividend directly to the U.S. shareholder including the amount in income.[39] Special computations are required for post-1962 earnings and profits of lower-tier subsidiaries.[40] For more information, refer to Treasury Regulation §7.367(b)-3(b&c).

2. IRC §1246 Amounts

The regulations provide that any IRC §1246 amount included in income as a result of IRC §367(b) is treated as gain from the sale or exchange of a non-capital assets to the extent attributable to post-1962 earnings-and-profits, and as dividends paid in cash immediately prior to the exchange to the extent attributable to pre-1963 earnings and profits required to be included as part of the "all earnings and profits amount".[41]

3. IRC §1248 Amounts

Any IRC §1248 amount included in a U.S. person's gross income is treated as a dividend received from a foreign corporation.[42]

j. Special Rules

There are special rules for computing the IRC §1248 and IRC §1246 amounts. However, they are beyond the scope of this manual. Please refer to the regulations for additional information.

k. Exchanges Described In More Than One Code Provision

Special rules exist for exchanges described in more than one section of subchapter C of the Code. For example, an exchange could be described in IRC §354 and §351. Treasury Regulation §7.367(b)-4 provides guidance as to which code provisions are controlling for purposes of IRC §367(b). For more information, refer to Treasury Regulation §7.367(b)-4.

I. Proposed Regulations

On August 25, 1991, the Internal Revenue Service issued a new set of proposed regulations under IRC §367(b). The rules proposed by the regulations currently have no force or effect, but will amend and replace the existing temporary regulations now in effect. The proposed regulations will be effective thirty days after they are published as final regulations in the Federal Register.

m. Summary

IRC §367(b) applies only to the transactions specifically described in the regulations. Unless the transfer is specifically addressed by the regulations under IRC §367(b), nonrecognition treatment is allowed. As a general rule under IRC §367(b), inbound transfers will result in gain recognition while foreign-to-foreign exchanges will not. In the case of foreign-to-foreign transfers, the main tax avoidance concern of the statute and regulations is circumvention of IRC §1248. The rules under IRC §367(b) are extremely complex as are many of the transactions covered by this code section. Accordingly, a strong working knowledge of Subchapter C of the Internal Revenue Code is required to both fully understand the implications of the transactions involved, and the taxation of the transaction if it falls within the scope of the IRC §367(b).

This discussion is intended only to provide a brief overview of IRC §367(b), including the existing and temporary regulations. The temporary regulations do not reflect changes made by Public Law 99-514, Public Law 98-369, and Public Law 100-647. Additional guidance on IRC §367(b) transactions can be found in the regulations, in the examples found in Treas. Reg. §7.367(b)-13, and in the following articles:

"Earnings and Profits Aspects of Tax-Free Exchanges Involving Foreign Corporations Under Section 367(b) And Temp. Treas. Reg. §7.367(b)" John M. Peterson, Jr., ©1988 John M. Peterson Jr.; World Trade Institute: Intermediate Seminar on International Taxation; September 26-September 27, 1988

"Section 367(b) Aspects of Foreign Reorganization", Roger S. Siboni, World Trade Institute: Intermediate Seminar on International Taxation, March, 1990, San Francisco, CA.

"International Corporate Divisions and Liquidations Under Section 367", Ivan H. Humphreys, ©Ivan H. Humphreys 1994; World Trade Institute: Intermediate Seminar on International Taxation, December 5-December 6, 1994, San Francisco, CA.

"Sales and Exchanges of Stock in Foreign Corporations Under Sections 1248 and Section 367(b) and New Section 367(b) Regulations", John M. Peterson, Jr.,

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©1994 John M. Peterson, Jr.; World Trade Institute: Intermediate Seminar on International Taxation, August 24-August 26, 1994, San Francisco, CA.

"IRS's Evolving Objectives Culminate in Proposed Section 367 Regulations", Roger S. Siboni and A. Ashley Stone, 19 International Tax Journal No. 1, 1 (1993).

Finally, this discussion does not include the rules that will be in effect once the proposed regulations are finalized and in effect. Once the proposed regulations are in effect, refer to the final regulations for additional information.

For a good discussion of §367(b), see 920 Tax. Man. Port., *Foreign income – Other Transfers Under Sections 367 and 1491*

Footnotes

1. IRC §1248 provides that capital gain income from the sale of stock will be treated as ordinary income to the extent of the earnings and profits of the foreign corporation attributable to the stock. ***Note***: IRC §1248 had substantially more impact on a corporation's tax liability when there were differences between the tax rate on capital gain income and ordinary income.
2. TreasRegs. §7.367(b)-1(a)
3. TreasRegs. §7.367(b)-1(b)
4. TreasRegs. §7.367(b)-5(b)
5. TreasRegs. §7.367(b)-3(b)
6. TreasRegs. §7.367(b)-3(f)
7. TreasRegs. §7.367(b)-5(b)
8. IRC §337(a) provides that no gain or loss will be recognized to a liquidating corporation if §332 applies. Regulation §7.367(b)-5(b) provides that if the domestic corporation does not include the "all earning and profit amount" in income, the foreign corporation will not be treated as a corporation. This regulation section then states: "However, the provisions of the code other section 332 shall apply as if the foreign corporation were considered a corporation."
9. If §336 does apply to the foreign corporation, then this deemed sale may generate subpart F income.
10. TreasRegs. §7.367(b)-7(c)(2)
11. TreasRegs. §7.367(b)-5(c)
12. TreasRegs. §7.367(b)-1(c)
13. TreasRegs. §7.367(b)-9
14. TreasRegs. §7.367(b)-7(b)(1)&(2)
15. TreasRegs. §7.367(b)-9(c)
16. TreasRegs. §7.367(b)-9(b)(3)
17. TreasRegs. §1.367(b)-9(b)(4)
18. TreasRegs. §7.367(b)-9(e)
19. TreasRegs. §7.367(b)-7(c)
20. TreasRegs. §7.367(b)-7(c)(2)(i)
21. TreasRegs. §7.367(b)-7(c)(2)(ii)
22. TreasRegs. §7.367(b)-6(a)
23. TreasRegs. §7.67(b)-1(c)
24. IRC §1246(c)
25. TreasRegs. §7.367(b)-6(b)

26. TreasRegs. §7.367(b)-6(b)
27. TreasRegs. §7.367(b)-6(c)(1)
28. TreasRegs. §7.367(b)-8(a)
29. TreasRegs. §7.367(b)-9(f)
30. IRC §1248(f)(1)
31. TreasRegs. §7.367(b)-13, example 17(a)
32. TreasRegs. §7.367(b)-10(c)
33. TreasRegs. §7.367(b)-10(l)(3)(i)
34. TreasRegs. §7.367(b)-10(l)
35. TreasRegs. §7.367(b)-1(c) for transfers occurring before 7/20/98. For transfers after 7/19/98, see TreasRegs. §1.367(b)-1(c)
36. TreasRegs. §7.367(b)-(1)(c)(1)
37. TreasRegs. §7.367(b)-1(c)(2)
38. TreasRegs. §7.367(b)-1(b)
39. TreasRegs. §7.367(b)-3(b)
40. TreasRegs. §7.367(b)-3(f)
41. TreasRegs. §7.367(b)-3(e)
42. TreasRegs. §7.367(b)-3(a)
43. TreasRegs. §7.367(b)-3(g)(2)

Section 19.5 Other Transactions Treated As Exchanges: IRC §367(c)

Contents:

Training Objectives:

In limited situations, specific transactions will be treated as exchanges subject to IRC §367, regardless of whether the transaction is an exchange or not. The purpose for such treatment is to limit the availability of nonrecognition treatment of gains resulting from transfers between U.S. persons and foreign corporations in order to prevent the avoidance of U.S taxation. IRC §367(c) provides for gain recognition for specific "other" transactions. At the end of this section, you will be able to do the following:

1) Determine which transfers fall within the scope of IRC §367(c); and
2) Determine the tax implications to the transferor and the transferee when a transfer falls within the provisions of IRC §367(c).

a. In General

1. Transactions To Be Treated As Exchanges-IRC §355 Distributions

For purposes of IRC §367(c), any distribution described in IRC §355, or in IRC §356 to the extent it relates to IRC §355, by a domestic corporation will be treated as an exchange regardless of whether it is an exchange or not.[1]

A taxpayer can prevent automatic gain recognition under IRC §367(c) by Requesting a ruling and establishing that the distribution is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax.

In the case of any distribution to which IRC §367(c) applies and there is no transfer described in IRC §367(a)(1), IRC §367(b) will apply.[2] Accordingly, a foreign corporation will be considered a corporation on a distribution to which IRC §355 applies to the extent provided in Regulation Sections 7.367(b)(1) through 7.367(b)-12.

2. Transactions To Be Treated As Exchanges - Contribution Of Capital To A Controlled Corporation.

IRC §367(c) provides that any transfer of property to a foreign corporation as a contribution to capital of such foreign corporation by one or more persons who immediately after the transfer own stock possessing at least 80 percent of the total combined voting power of all classes of stock of such corporation shall be treated as an exchange of property for stock of the foreign corporation equal to the fair market value of the property transferred.[3]

In the case of any distribution to which IRC §367(c) applies and where there is no transfer described in IRC §367(a)(1), a foreign corporation shall be considered to be a corporation on such transfer to the extent and upon fulfillment of any applicable conditions specified in Regulation Sections 7.367(b)(1) through 7.367(b)-12, if the transfer is an exchange described in IRC §367(b) or made in connection with an exchange described in that section.[4]

b. Summary

Internal Revenue Code §367(c) applies to specific other transactions that are otherwise not treated as exchanges subject to IRC §367. For more information, refer to IRC §367(c) and the regulations thereunder.

Footnotes

1. TreasRegs. §7.367(c)-1(a)
2. TreasRegs. §7.367(c)-1(c)
3. TreasRegs. §7.367(c)-2(a)
4. TreasRegs. §7.367(c)-2(d)

Section 19.6 Transfers Of Intangible Property To A Foreign Corporation: IRC §367(d)

Contents:

Training Objectives:

IRC §367(a) provides the general rules governing the recognition of gain on most outbound transfers. However, for transfers of intangible property to a foreign corporation in an exchange described by IRC §351 or §361, special rules apply to determine the recognizable gain. At the end of this section, your should be able to do the following:

1) Determine which transfers fall within the scope of IRC §367(d); and
2) Determine the tax implications to the transferor and the transferee when a transfer falls within the provisions of IRC §367(d).

a. In General

As a general rule, IRC §367(a) does not apply to outbound transfers of any intangible property described by IRC §351 or §361 where the transferor is a U.S. person. Rather, IRC §367(d) and the regulations thereunder controls the treatment of outbound transfers of intangible property. Under IRC §367(d)(2)(A), the transfer of an intangible in an exchange described in IRC §351 or §361 will be treated as a transfer pursuant to a "deemed" sale in which the actual payments made are contingent upon the productivity, use or disposal of the intangible property.[1] Sales and licenses of intangibles are not subject to IRC §367(d) since these transactions are not described in IRC §351 or §361.[2] However, IRC §482 may apply to such sales and licensing transactions.

Under IRC §367(d), a U.S. transferor must include in income amounts which reasonably reflect the amounts that would have been received annually had the U.S. transferor entered into a contract for the sale of the intangible in exchange for payments contingent upon the productivity or use of the intangible over the properties useful life. In the case where the intangible is disposed of by the transferee, the transferor must include in income the amount that would have been received had the transferor sold the intangible in an exchange for payments which are contingent upon the disposition of the asset. The amount taken into account will be commensurate with the income attributable to the intangible asset transferred.

The amounts included in income by the U.S. transferor as a result of the application of IRC §367(d) are treated in all cases as U.S. source ordinary income. However, the transferee is permitted to reduce its earnings and profits by such amounts to the extent such amounts are included in income of the transferor.[3]

b. Definition Of Intangible Property Subject To IRC §367(d)

For purposes of IRC §367(d), intangible property is defined broadly by referencing IRC §936(h)(3)(B), to mean the following:

1. Any patent, invention, formula, process, design, pattern, or know how;
2. Any copyright, literary, musical, or artistic composition;
3. Any trademark, trade name, or brand name;
4. Any franchise, license, or contract;
5. Any method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
6. Any similar item which has substantial value independent of the services of the individual.

Contracts and contract rights also fall within the definition of intangible property.

c. Exceptions To The Definition Of Intangible

Although the definition of intangible property is quite broad, two possible exceptions might exist. First of all, there exists strong evidence in the committee reports that suggests that the regulations should exclude foreign goodwill, going concern value, tradenames, trademarks, and similar "marketing" intangibles provided that the active business exception is satisfied.[4] Secondly, even where an outbound transfer involves intangible property as described by IRC §936(h)(3)(B), IRC §367(d) does not apply unless it involves a transfer of property described in IRC §351 or §361. For example, Regulation §1.367(a)-5T(e) provides rules governing transfers of intangibles in an IRC §332 liquidation. Finally, transfers of intangible property imbedded in tangible property are not treated as a transfer of intangible property if the purchaser does not acquire any rights to exploit the intangible property other than rights relating to the resale of tangible property under normal commercial practices.[5]

d. The Toll Charge

The amount required to be included in income of the U.S. transferor varies depending upon whether:

1) The intangible property is disposed of by the transferee;
2) The intangible is used by the transferee in its trade or business; or
3) The transferee's stock is disposed of to a related or unrelated person.

1. In General

When intangible property is transferred to a foreign corporation in an exchange subject to IRC §367(d), the U.S. transferor will include in income over the useful life of the property annual payments contingent on the productivity or use of the property.[6] The amount included in income should reflect the appropriate arm's-length charge for the use of the property. The appropriate charge is determined under the provisions of IRC §482 and regulations thereunder,[7] and is treated as ordinary U.S.- source income to the transferor. The deemed payment is reduced by any royalty or other periodic payment made or accrued by the transferee to an unrelated person for the right to use the intangible property. The earnings and profits of the transferee corporation are reduced by the amount of the deemed payment, and for purposes of Subpart F of the Code, the deemed payment may be treated as an expense apportioned and allocated to Subpart F income.[8]

If the transfer arrangement covers more than one year, then the amount charged for use of the intangible in each taxable year may be adjusted to ensure the commensurate with income standard is met. The annual adjustment is made on a fact and circumstances basis,[9] over the entire period during which the property has value.[10]

2. Transfer Of Stock Of Transferee To An Unrelated Person

If intangible property is transferred by a U.S. person to a foreign corporation in an exchange subject to IRC §367(d), and within the useful life of the intangible property the U.S. transferor disposes of the stock of the transferee foreign corporation to an unrelated person, then the U.S. transferor will be treated as having simultaneously sold the intangible property to the person acquiring the stock of the transferee. Any resulting gain (but not loss) must be recognized as U.S.-source income. The gain is computed as the difference between the fair market value of the intangible and the U.S. transferor's former adjusted basis in that property (determined on the date of the original transfer to the transferee foreign corporation whose stock was sold). Any gain that would have been required to recognized as the result of any other code provision will be reduced by any gain recognized as a result of the application of IRC §367(d).[11] Basis adjustments are required by the unrelated person acquiring the foreign corporation's stock.[12]

3. Transfer Of Stock Of Transferee To A Related Person

If intangible property is transferred by a U.S. person to a foreign corporation in an exchange subject to IRC §367(d), and within the useful life of the intangible property the U.S. transferor disposes of the stock of the transferee foreign corporation to a related U.S. person, then the following rules apply:

1) Each U.S.-related person receiving the stock of the transferee foreign corporation shall be deemed to receive a right to receive a proportionate share of the contingent annual payments that would otherwise be deemed to be received by the U.S. transferor.
2) Each related U.S. person will include in gross income over the useful life of the property a proportionate share of the amount that would have been included in the income of the U.S. transferor as U.S.-source income.[13]

The rules of this section would apply to any subsequent transfer of the stock in the transferee foreign corporation to another related person.[14] In addition, the regulations mandate certain required adjustments to various tax attributes of the parties subject to the exchange. Refer to Regulation §1.367(d)-1T(e)(2) for more information.

4. Transfer Of Stock In Transferee To Related Foreign Corporation

If intangible property is transferred by a U.S. person to a foreign corporation in an exchange subject to IRC §367(d), and within the useful life of the intangible property the U.S. transferor disposes of any of the stock of the transferee foreign corporation to one or more related foreign corporations, then the U.S. transferor will continue to include in income the deemed payment that would have been required under IRC §367(d).[15]

5. Disposition Of Transferred Intangible Property By Transferee Foreign Corporation

If a U.S. person transfers intangible property to a foreign corporation subject to the provisions of IRC §367(d) and the regulations thereunder, and within the useful life of the intangible property the transferee foreign corporation subsequently disposes of the intangible property to an unrelated person, then the following applies:

1) The U.S. transferor will be required to recognize gain from U.S. sources equal to the excess of the fair market value of the transferred intangible property on the date of disposition and the U.S. transferor's former adjusted basis in the property; and
2) The U.S. transferor will be required to include as income from U.S. sources a deemed payment for any part of the taxable year that the intangible property was held by the transferee foreign corporation, and will not be required to recognize any further deemed payments with respect to the transferred intangible property.[16]

6. Special Rules

Several special rules apply to exchanges or transfers affected by IRC §367(d).

A. Establishment Of Accounts Receivable

If a U.S. person is required to recognize income as a result of either a transfer of intangible property to a foreign corporation, a subsequent transfer of stock of the transferee foreign corporation to a related person, or disposition of the transferred intangible property by the transferee foreign corporation, but the amount deemed to be received is not paid, then the U.S. person may establish an account receivable from the transferee foreign corporation equal to the amount deemed paid.[17]

A separate account receivable must be established for each income year. Any account receivable outstanding three taxable years after the account is established will be treated as a contribution of capital to the foreign transferee and will increase the transferor's basis in the transferee's stock.[18]

B. Treating Transfer As A Sale

A U.S. person that transfers intangible property to a foreign corporation in a transaction subject to IRC §367(d) may elect to recognize as ordinary income the difference between the fair market value of the intangible property and the U.S. transferor's adjusted basis in the property if it meets one of the following conditions:

- The intangible property constitutes an operating intangible as defined by 1.367(a)-1T(d)(5)(ii);
- The transfer of the intangible property is either legally required by the government of the country in which the transferee corporation is organized as a condition of doing business in that country, or is compelled by a genuine threat of immediate expropriation by the foreign government; or
- The U.S. person transferred the intangible property to the foreign corporation within three months of the organization of that corporation and as part of the original plan of capitalization of that corporation;Immediately after the transfer, the U.S. person owns at least 40 percent but not more than 60 percent of the total voting power and total value of the stock of the transferee foreign corporation;Intangible property constitutes at least 50 percent of the fair market value of the property transferred to the foreign corporation by the U.S. transferor; andThe transferred intangible property will be used in the active conduct of a trade or business outside the U.S., and will not be used in the connection with manufacture of sale of products in or for use or consumption in the U.S.[19]

The election to treat the transfer as a sale is made in accordance with the notification requirements of IRC §6038B and the regulations thereunder.

C. Intangible Property Transferred From Branch With Previously Deducted Losses

Where income is required to be recognized under IRC §904(f)(3) and the regulations thereunder or under Regulation §1.367(a)-(6T) upon transfer of intangible property of a foreign branch that had previously deducted losses, then the income recognized under those sections will be credited against the amount required to be recognized in the current or future taxable years as a result of IRC §367(d).[20]

D. Coordination With IRC §482

IRC §367(d) will not apply where there is an actual sale or license of intangible property by a U.S. person to a foreign corporation. If an adjustment is required under IRC §482 for the actual sale or license, IRC §367(d) will not apply to the required adjustment.

If a U.S. person transfers intangible property to a related foreign corporation in a transaction described by IRC §351 or §361, no sale or license subject to adjustment under IRC §482 will have deemed to have occurred.[21] Instead, the U.S. person shall be treated as having made a transfer of intangible property that is subject to IRC §367(d).

A purported sale or license of an intangible may be disregarded and treated as a transfer subject to IRC §367(d) in the following situation:

- The sale or license is made to a foreign corporation in which the transferor holds or is acquiring an interest; and
- The economic substance of the sale differs so significantly from the terms of the sale or license that would have been obtained between unrelated persons that the sale or license is a sham.[22]

E. Determination Of Fair Market Value

The fair market value of the transferred property is the amount of the single payment that would have been paid by an unrelated purchaser in an arm's-length transaction. The allocation of a portion of the purchase price to intangible property agreed to by the parties to the transaction shall not necessarily be controlling.[23]

F. Other Anti-Abuse Rules

If a U.S. person transfers intangible property to a domestic corporation to avoid the affects of IRC §367(d) and thereafter transfers the stock of the corporation to a related foreign corporation, then the U.S. person will be treated as having transferred the intangible property directly to the foreign corporation for purposes of IRC §367(d).[24]

e. Summary

As a general rule, IRC §367(d) takes priority over IRC §367(a). IRC §367(d) was enacted to significantly limit certain perceived abuses, particularly where valuable intangible property is developed and expensed in the U.S., and the related income stream is shifted offshore through a tax-free exchange described in either IRC §351 or §361. The commensurate with income requirement enacted by Congress with the 1986 Tax Reform Act has effectively eliminated any abuse in this area. For more information, refer to IRC §367(d) and the regulations thereunder, and the following articles:

"Outbound Transfers of Intangible Property Under Section 367(d) After the New Section 482 Regulations[1]", Bruce N. Davis, Esq., 23 Journal of Taxation 10, October 14, 1994, p. 471.

"Outbound Transfers of Appreciated Property Under Section 367", C. David Swenson, Esq., and Thomas A. O'Donnell, Esq., © 1994 C. David Swenson & Thomas A. O'Donnell; World Trade Institute, 1994.

Footnotes

1. This is the commensurate with income standard added by Congress in the 1986 Tax Reform Act that is also found IRC §482.
2. IRC §482 White Paper, 1988-2 C.B. at 474
3. IRC §367(d)(2)(B)
4. TreasRegs. §1.367(d)-1T(b)
5. TreasRegs. §1.482-3(f)
6. TreasRegs. §1.367(d)-1T(c)
7. TreasRegs. §1.367(d)-1T(c)(1) cross-references TreasRegs. §1.482-2(d)
8. TreasRegs. §1.367(d)-1T(c)(2)
9. TreasRegs. 1.482-4(f)(2(i)
10. TreasRegs. §1.367(d)-1T(c)(3)
11. TreasRegs. §1.367(d)-1T(d)(1)
12. TreasRegs. §1.367(d)-1T(d)(2)
13. TreasRegs. §1.367(d)-1T(e)(1)
14. TreasRegs. §1.367(d)-1T(e)(1)(iv)
15. TreasRegs. §1.367(d)-1T(e)(3)
16. TreasRegs. §1.367(d)-1T(f)(1)
17. TreasRegs. §1.367(d)-1T(g)(1)(i)
18. TreasRegs. §1.367(d)-1T(g)(1)(ii)
19. TreasRegs. §1.367(d)-1T(g)(2)
20. TreasRegs. §1.367(d)-1T(g)(3)
21. TreasRegs. §1.367(d)-1T(g)(4)
22. TreasRegs. §1.367(d)-1T(g)(4)(ii)
23. TreasRegs. §1.367(d)-1T(g)(5)
24. TreasRegs. §1.367(d)-1T(g)(6)

Section 19.7 IRC §367(e) Distributions Described In IRC §355 And Liquidations Under IRC §332

Contents:

Training Objectives:

Internal Revenue Code §367 was enacted to prevent appreciated property from being transferred beyond the U.S. taxing jurisdiction in certain nonrecognition transactions. IRC §367(a) addresses most outbound transfers of appreciated property. IRC §367(b) addresses inbound and foreign-to-foreign exchanges, and IRC §367(c) addresses other transactions that might otherwise not be treated as exchanges within the scope of IRC §367. Finally, IRC §367(d) provides for special rules for recognition of gain on outbound transfers of intangible property.

In addition to these rules, IRC §367 provides specific rules for distributions described in IRC §355 and liquidations under IRC §332 that are not specifically addressed by IRC §367(a) through (d). The rules applicable to such transfers are found in IRC §367(e), and the regulations thereunder.

At the end of this section you should be able to do the following:

1) Determine which transfers fall within the scope of IRC §367(e); and
2) Determine the tax implications to the transferor and the transferee when a transfer falls within the provisions of IRC §367(e).

a. In General

Internal Revenue Code §367(e) was enacted as part of the 1986 Tax Reform Act, and provides for the treatment of distributions described in IRC §355 or liquidations under IRC §332 as follows:

1. Distributions Described In §355

In the case of any distribution described in §355 (or so much of §356 as relates to §355) by a domestic corporation to a person who is not a United States person, to the extent provided in the regulations, gain shall be recognized under principles similar to the principles of this section.

2. Liquidations Under §332

In the case of any liquidation to which §332 applies, except as provided in regulations, subsection (a) and (b)(1) of §337 shall not apply where the 80-percent distributee (as defined in §337(c)) is a foreign corporation.

b. Distributions Described In IRC §355

IRC §367(e)(1) specifically addresses distributions described in IRC §355. Although the regulations under IRC §367(a) refer to transactions described in IRC §355, IRC §367(a) does not control the treatment of IRC §355 transactions since corporate status of the transferee is not required in order for the IRC §355 nonrecognition provisions to apply. Special rules under IRC §367(e)(1) were enacted to close this perceived loophole in IRC §367(a).

The general effect of the rules under IRC §367(e)(1) is to require gain recognition by a domestic corporation if it distributes stock or securities in either a domestic or foreign corporation to a distributee that is not a U.S. person. There are exceptions to this general rule.

1. Required Gain Recognition

If a distribution is made to which IRC §355 applies, and the distributing domestic corporation transfers stock in either a domestic or foreign corporation to a non-U.S. person, then the distributing domestic corporation will recognize gain on the distribution under IRC §367(e)(1) unless a specific exception to gain recognition exists in the regulations.[1] The amount of gain recognized is equal to the excess of the fair market value of the stock or securities over the corporation's adjusted basis in the stock.[2] The distribution is not treated as a dividend by the distributee.[3] Accordingly, an IRC §355 distribution subject to gain recognition under IRC §367(e) will not be subject to the U.S. withholding tax on dividends.

2. Exception To The Gain Recognition Requirement

Regulation §1.367(e)-1(b)(4) specifically provides that gain recognition is required regardless of the application of IRC §367(a) and the regulations thereunder. Instead, there are only three exceptions to avoid gain recognition under IRC §367(e)(1) when stock or securities are transferred to a non-U.S. person in a transfer described in IRC §355. These exceptions are as follows:

A. No gain will be recognized by the distributing domestic corporation if immediately after the distribution both the distributing and the controlled corporations are U.S. real property holding corporations as defined by IRC §897(c)(2).[4]

B. No gain will not be recognized by a domestic corporation distributing stock of a domestic controlled corporation to a foreign distributee if it meets the following conditions:
   - More than 80 percent of the value of the outstanding stock of the domestic controlled corporation is distributed with respect to one or more classes of the distributing corporation's outstanding stock that is regularly traded on an established securities market,[5] and the reporting requirements of §1.367(e)-1T(c)(iii) are satisfied.
   - At the time of the distribution, the distributing corporation does not know or have reason to know that the foreign distributee owns more than 5 percent (by value, directly or constructively) of the publicly traded stock of the distributing corporation.[6]

If the distribution also qualifies for nonrecognition under the U.S. real property holding corporation provisions, then the U.S. real property holding corporation provisions will control the treatment of the transfer.[7]

C. Gain is not recognized on the distribution of the stock or securities of a domestic controlled corporation to a foreign distributee if the foreign distributee is a qualified foreign distributee. See §1.367(e)-1T(c)(3) for more information.

3. Effective Date Of Regulations

<u>Final Regulations</u>

The regulations under IRC §367(e)(1) are effective for distributions occurring on or after January 16, 1993. However, a corporation may elect to apply these regulations retroactively to all distributions made after February 15, 1990, and before January 16, 1993, by timely filing an original or amended return for the year of the distribution, and otherwise complying with the provisions of this section.

<u>Temporary Regulations</u>

The above final regulations were amended and re-issued as temporary regulations. The prior final and new temporary regulations are similar, but the new temporary regulations altered the gain-recognition-agreement exception. These temporary regulations are effective for distributions occurring on or after September 13, 1996. However, taxpayers can elect to apply these regulations to distributions occurring on or after December 31, 1995

c. Distributions In Complete Liquidation Of A Subsidiary Under IRC §332.

With the exception of distributions under IRC §355 and distributions in complete liquidation of a subsidiary under IRC §332, the 1986 Tax Reform Act eliminated the opportunity to distribute appreciated corporate property without recognizing gain on the distribution. The limitations on non-recognition treatment of distributions under IRC §355 as a result of IRC §367(e)(1) were already discussed. This discussion will focus on the effects of IRC §367(e)(2) on distributions in complete liquidation of a subsidiary under IRC §332.

It is important to note that the temporary regulations under IRC §367(e)(2) expired on January 12, 1993.[19] Accordingly, there are currently no regulations under IRC §367(e)(2) with any force or effect. This discussion assumes that the expired temporary regulations will be re-promulgated and issued in final form without modification. Otherwise there is little guidance for purposes of interpreting this portion of the statute.

1. In General

Although the statute specifically refers to transactions under IRC §332, IRC §367(a) does not apply to the complete liquidation of a subsidiary where at least 80 percent of the stock is owned by a foreign corporation.[20] Rather, IRC §367(e)(2) controls the treatment of the complete liquidation of a subsidiary in an outbound transfer.

IRC §367(e)(2) provides that if a domestic corporation distributes property in complete liquidation to a foreign corporation that owns at least 80 percent of the outstanding stock of the domestic corporation, then except as provided in the regulations, gain will be recognized by the domestic corporation on the distribution.[21]

The gain required to be recognized is the excess of the fair market value of each distributed item over the distributing corporation's adjusted basis in each item of property.[22] This is the only provision that permits loss to be recognized as a result of the application of IRC §367 to any exchange.[23] Ordinary and capital losses are recognized to the extent they don't exceed the ordinary and capital gains recognized on the liquidation. In addition, losses on property contributed to the distributing corporation within the preceding five years are not recognized.[24] Finally, losses recognized under IRC §367(e)(2) are not subject to loss disallowance or deferral under IRC §267.[25]

2. Distribution Of Partnership Interests

This section provides that if the domestic corporation distributes a partnership interest in complete liquidation, then the domestic corporation will be treated as having distributed a proportionate share of the property of the partnership.[26] This rule applies to second tier and lower partnership interests as well. For any gain recognized, the foreign corporation's basis in the distributed partnership interest will be increased. Furthermore, the foreign corporation's basis in the distributed partnership interest will be decreased by any losses recognized.[27] These rules do not apply to any limited partnership interest regularly traded on an established securities market.[28]

3. U.S. Trade Or Business Exception To Gain Recognition

A domestic corporation liquidating into a foreign corporation will not be required to recognize gain or loss under IRC §367(e)(2) if the property is used by the foreign corporation in the conduct of a U.S. trade or business. This exception is condition on the following:

A. The foreign distributee corporation is not a controlled foreign corporation;
B. The foreign distributee corporation uses the property in the conduct of a trade or business in the U.S. for ten years beginning on the date of distribution; and
C. The domestic and foreign corporations attach a required statement to their U.S. income tax returns stating that the property distributed is used in a U.S. trade or business and has not been sold within the ten year period.[29] The statement has other requirements which are too lengthy to discuss here. Refer to Regulation §1.367(e)-2T(b)(2)(B) for more information.

This nonrecognition exception does not apply to intangible property described in IRC §936(h)(3)(B), which is subject to the provisions of IRC §367(d). For more information on the treatment of intangible property, refer to Section 19.6, Water's-Edge Manual.

4. Exception To Gain Recognition For Distribution Of U.S. Real Property Interests.

A domestic corporation does not recognize gain under IRC §367(e)(2) on the distribution of a U.S. real property interest (other than stock in a former U.S. real property holding corporation which is treated as a U.S. real property interest for five years) in complete liquidation of the domestic corporation into a foreign corporation. This exception takes precedence over the U.S. trade or business exception where the liquidation meets both exceptions.[30]

5. Distribution By A Foreign Corporation

A foreign corporation is generally not required to recognize gain if it makes a distribution of property in complete liquidation under IRC §332 to another foreign corporation that owns at least 80 percent of the voting stock of the liquidating corporation.[31] However, if the liquidating foreign corporation distributes property that was used in a U.S. trade or business to another foreign corporation, gain will be recognized by the distributing foreign corporation unless the property is used by the distributee for ten years in the conduct of a U.S. trade or business, and the distributor and distributee attach a required statement to their tax returns for the taxable year that includes the distribution.[32]

There are two exceptions to this rule. For certain CFC-to-CFC liquidations, no gain will be recognized on distributions of property used in a U.S. trade or business if:

A. Both the distributor and distributee are CFC's at the time of distribution.
B. Immediately after the distribution, the distributee must use the property in the conduct of a U.S. trade or business.
C. There has not been any prior outbound or foreign-to-foreign §332 liquidation of another corporation into the distributing corporation in a transaction subject to IRC §367(e)(2), unless the prior distribution was of a CFC into a CFC.
D. If the distributee is entitled to benefits under a comprehensive income tax treaty, then the distributing corporation must also have been entitled to benefits under a comprehensive income tax treaty.[33]

If the liquidation does not involve two CFC's, gain recognition can still be avoided on the distribution of property used in the conduct of a U.S. trade or business for the 10-year period if:

A. The distributee continues to use the distributed property in the conduct of a U.S. trade or business for the 10-year period following the date of distribution; and
B. The distributor and distributee attach the required statement to their returns filed for the taxable year of the distribution.[34]

If the required statement is not provided by the distributee corporation, then the Commissioner will decide whether the nonrecognition provisions apply.[35] If gain recognition is required because a foreign corporation distributes property under IRC §332 and the property ceased to be used in a U.S. trade or business after December 31, 1986 and within ten years of the date of liquidation, IRC §864(c)(7) will govern the treatment of any gain recognized.[36]

Finally, the distribution of a U.S. real property interest to a foreign corporation under IRC §332 does not require gain recognition under IRC §367(e)(2). Instead, the taxability of the transaction is governed by the regulations under IRC §897.[37]

d. Transitional Rule For Certain Treaty Provisions

For a distribution by a domestic corporation, IRC §367(e)(2) will not apply if the property was distributed after July 31, 1986, and before September 27, 1987, in a distribution that would have been subject to IRC §367(e) but for the provisions of Notice 87-5[38], and the foreign distributee is a resident of a foreign country with a U.S. tax treaty in effect at the time of the distribution which contained a provision barring discrimination based on capital ownership and the corporation is not denied the benefit of nondiscrimination under that treaty.[39]

e. Effective Date

IRC §367(e)(2) is effective for distributions on or after August 1, 1986, except that it will not apply to any corporation completely liquidated prior to June 10, 1987, into a corporation organized in a country which then had a treaty with the United States.[40]

f. Summary

Internal Revenue Code Section 367(e) specifies the rules for distributions under IRC §355, and distributions involving the complete liquidation of a subsidiary under IRC §332. For more information, refer to IRC §367(e) and the regulations thereunder, and the following articles:

"Stock Distributions Under Section 367(e)(1): Final Regulations" Bruce N. Davis, Esq., 22 Tax Management International Journal No. 5, 237 (1993)

"Outbound Section 355 Distributions and Liquidations under Section 367(e)(Part I), Bruce N. Davis, Esq., 22 Tax Management International Journal No. 9, 455 (1993)

"Outbound Section 355 Distributions and Liquidations under Section 367(e)(Part II), Bruce N. Davis, Esq., 22 Tax Management International Journal No. 9, 563 (1993)

Footnotes

1. TreasRegs. §1.367(e)-1T(b)(1)
2. TreasRegs. §1.367(e)-1T(b)(2)
3. TreasRegs. §1.367(e)-1T(b)(3)
4. TreasRegs. §1.367(e)-1T(c)(1)
5. TreasRegs. §1.367(e)-1T(c)(2)(i)(A)
6. TreasRegs. §1.367(e)-1T(c)(2)(i)(B)
7. TreasRegs. §1.367(e)-1T(c)(2)(v)
8. TreasRegs. §1.367(e)-1T(c)(3)(ii)(A)(1)
9. TreasRegs. §1.367(e)-1T(c)(3)(ii)(A)(2)
10. TreasRegs. §1.367(e)-1T(c)(3)(ii)(C)(2)
11. TreasRegs. §1.367(e)-1T(c)(3)(ii)(B)
12. TreasRegs. §1.367(e)-1T(c)(3)(ii)(E)
13. TreasRegs. §1.367(e)-1T(c)(3)(ii)(D)
14. TreasRegs. §1.367(e)-1T(c)(3)(ii)(F)
15. TreasRegs. §1.367(e)-1T(c)(3)(G)
16. TreasRegs. §1.367(e)-1T(c)(3)(v)
17. TreasRegs. §1.367(e)-1T(c)(3)(iii)
18. TreasRegs. §1.367(e)-1(c)(3)(viii)
19. It is important to note that the temporary regulations under IRC §367(e)(1) and IRC §367(e)(2) were issued at the same time. However, only the regulations under IRC §367(e)(1) were issued in final form. As a result, the regulations under IRC §367(e)(2) expired three years after they were issued in accordance with IRC §7805.
20. TreasRegs. §1.367(e)-2T(a)(2)
21. TreasRegs. §1.367(e)-2T(b)(1)(i)
22. TreasRegs. §1.367(e)-2T(b)(1)(i)
23. TreasRegs. §1.367(e)-2T(b)(1)(ii)
24. TreasRegs. §1.367(e)-2T(b)(1)(ii)
25. IRC §267(a)(1)
26. TreasRegs. §1.367(e)-2T(b)(1)(iii)(A)
27. TreasRegs. §1.367(e)-2T(b)(1)(iii)(B)
28. TreasRegs. §1.367(e)-2T(b)(1)(iii)(C)
29. TreasRegs. §1.367(e)-2T(b)(2)(i)(A)
30. TreasRegs. §1.367(e)-2T(b)(2)(ii)
31. TreasRegs. §1.367(e)-2T(c)(1)
32. TreasRegs. §1.367(e)-2T(c)(2)
33. TreasRegs. §1.367-2T(c)(2)

34. TreasRegs. §1.367(e)-2T(c)(2)(i)
35. TreasRegs. §1.367(e)-2T(c)(2)(i)(C)
36. TreasRegs. §1.367(e)-2T(c)(2)(ii)
37. TreasRegs. §1.367(e)-2T(c)(3)(iii)
38. 1987-1 C.B. 416 (Note: this Notice was withdrawn by Notice 87-66, 1987-2 C.B. 376)
39. Notice 87-66, 1987-2 C.B. 376
40. TreasRegs. §1.367(e)-2T(d)

Section 19.8 Exchanges Described In More Than One Code Section

Contents:

a. In General

Training Objectives

In some instances, a transfer will be described in more that one code provision. Accordingly, confusion over which code provision is controlling may arise. Both IRC §367 and the supporting regulations have attempted to provide some guidance in such instances. At the end of this section, you will be able to do the following:

1) Determine situations where more than one code section applies to a transaction; and
2) Determine which code provision is controlling.

a. In General

In certain instances, transfers of property subject to the provisions of IRC §367 may be described in more than one of the nonrecognition provisions of the Code. Clarification has been provided by the Internal Revenue Code in some instances. In addition, the Regulations provide the following additional clarifications:

1. Section 1.367(b)-4 applies to an exchange of stock by a US shareholder in an exchange described in §351 or an exchange described in §354 made in a reorganization described in §368(a)(1)(B).

2. For exchanges described in both IRC §354 and §1036, the exchange will be considered described by IRC §1036 unless the stock surrendered is stock to which an amount has been attributed under Treas. Regs. §§7.367(b)-5 through 7.367(b)-12. In that event, IRC §367(b) will apply to the amounts attributed to the stock instead of IRC §1036.[1]

Please refer to the regulations for additional guidance where exchanges occur which fall within more than one nonrecognition provision.

Footnotes

1. TreasRegs. §7.367(b)-4(c)

Section 19.9 Conclusion

Contents:

a. Conclusion

Transactions within the nonrecognition provisions of Subchapter C of the Internal Revenue Code can be complex, especially when multiple Internal Revenue Code provisions affect any given transfer. Due to the complexity of some of the transfers that fall within the provisions of IRC §367, a working knowledge of the organization, reorganization, merger, and liquidation code provisions is required. In addition, it will be imperative to know which Code provisions take precedence in any given situation.

The differences between California and federal taxing jurisdictions do not ease the task of auditing transfers under IRC §367. Rather, the differences in California law, the interjection of the intercompany transaction rules, and the availability of worldwide combined reporting, water's-edge combined reporting, and separate reporting (when applicable) as California return filing methods for corporations further complicate an already complex audit issue for California purposes.